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Recommendations and standards

Other deliverables for noting

Green Paper on Trade Finance as a tool for Trade Facilitation

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I. Executive summary

1. The objective of this United Nations Centre for Trade Facilitation and Electronic Business (UN/CEFACT) project is to articulate the linkages and complementarities of Trade Facilitation activities with the financing of international commerce under the broad array of Trade Finance and Supply Chain Finance solutions.

2. In essence, getting everything right around the physical movement of goods by streamlining operations from education to logistics, and infrastructure to regulatory considerations (i.e. the commonly understood scope of Trade Facilitation) is important. However, in the absence of adequate and affordable levels of financing and risk mitigation, such activities will only partially allow importers and exporters to conduct trade in a sustainable way. Furthermore, the economic and development objectives will only be partially achieved.

3. Financing, in some form, supports the vast majority of trade flows, and lack of it has been identified almost globally as a serious obstacle to the growth and sustainability of enterprises—particularly Small and Medium Enterprises (SMEs). Suppliers linked to cross-border and international supply chains are often based in developing and emerging markets where the challenges of accessing affordable financing are further complicated. It is often the case that financing available locally in developing markets is simply too expensive for SMEs to take advantage of, thus the challenge is not only about access to finance, but also about the risk for banks in financing SMEs.

4. Trade Facilitation is a mature discipline and a critical contributor to development efforts either at the policy or transactional level. It does this by fostering the adoption, effectiveness and success of programs for simple, transparent and effective trade processes being deployed in both advanced and developing economies. The exclusion of financing as an element of Trade Facilitation efforts misses a critical commercial reality that underpins global trade flows, trade relationships and international supply chains. That is, the lack of adequate levels of financing is consistently identified as a major obstacle to the pursuit of additional opportunities in international markets.

5. In this context, this paper discusses the strategic importance to “bridge” Trade Facilitation, Trade Finance and Supply Chain Finance instruments, practices, and supporting technologies, and demonstrates that the inclusion of financing as an in-scope element of Trade Facilitation presents significant, untapped potential in trade-based international development. It does so concurrently from the perspective of Trade Facilitation practitioners and Trade Finance and Supply Chain Finance experts.

II. Trade and the need for financial support

6. International Trade is a long-enduring part of the human experience and of commerce—one that has come into increasingly sharp focus, since the 2008 global crisis, as a force for the creation of economic value, growth and recovery.

7. Despite the imperfections that persist in the current ecosystem around trade and investment, there is no denying that trade creates value, and is one of relatively few levers that can be influenced by public policy to affect change on a global scale. Many jurisdictions, including developing economies, are placing trade at the centre of their development strategies, and thus, at the centre of policy priorities – investing in the development of trade-related technical competencies and capacity (as reflected for instance in the European Union-

funded Hub & Spokes Program¹) and contributing to advances in market access through Trade Facilitation initiatives.

8. However, one element underpinning successful international trade—which has historically been underappreciated—is trade-related financing.

9. One outcome of the 2008 global financial and economic crisis, in the search for global solutions to a global problem, was significant focus on trade as an engine of recovery. The resulting realization was that over 80 per cent of merchandise trade flows could not take place without some element of the financing value proposition supporting and enabling those flows.

10. While industry metrics are not easily sourced, the recent focus on Trade Finance and Supply Chain Finance (arising directly from the 2008 crisis and its aftermath) has resulted in some investment of intellectual and research energy into these domains. This has facilitated a better understanding of the impact and value of financing in support of international commerce. This foundation can then lead to consideration of the potential in better linking Trade Finance and Supply Chain Finance to Trade Facilitation practices.

11. Prior to delving into the core of the discussion, however, it is worth setting the stage with a high-level overview of the nature of Trade Finance and Supply Chain Finance.

III. Trade Finance: four elements

Overview of Trade Finance

12. The expression ‘Trade Finance’ has very specific connotations for practitioners. It typically refers to the financing of trade flows on a short-term basis, with some institutions limiting Trade Finance to three hundred 60-day terms, and others extending up to twenty-four months. Transactions with longer tenors exist (i.e. longer periods of financing or exposure from the perspective of the lender) and are often referred to as ‘Medium or Long Term Trade Finance’. These might cover transactions extending up to fifteen years. One last category, known as ‘Project Finance’, typically involves major capital projects with timelines extending to twenty or even thirty years.

13. Trade Finance refers to traditional mechanisms and techniques for financing trade, such as Documentary Collections and Documentary Letters of Credit. On the short-term end of the spectrum, or at the longer tenor end of the business, Trade Finance is fundamentally about four elements (see figure 1):

- The facilitation of timely and secure payment (across borders). The provision of appropriate risk mitigation strategies and solutions in support of international trade.
- The support of information flow about the state of a trade transaction from the status of the physical shipment to the status of related financial flows.
- The provision of financing options and solutions for one or more of the parties engaged in trade.

¹ https://ec.europa.eu/europeaid/sites/devco/files/brochure-acp-trade-hubs-and-spokes-programme-ii-2014_en.pdf (Accessed 14 March 2017).

Figure 1: The four elements of Trade Finance

| Payment | Risk Mitigation | Information | Financing |
|---|--|---|---|
| <ul style="list-style-type: none"> • Secure • Timely & Prompt • Global • Low-cost • All leading currencies | <ul style="list-style-type: none"> • Risk Transfer • Country, Bank and Commercial Risk • Transport Insurance • Export Credit Insurance | <ul style="list-style-type: none"> • Financial flows • Shipment Status • Quality of Shipment • Letter of Credit systems include web & desktop solutions | <ul style="list-style-type: none"> • Available to importer or exporter • Several stages in the transaction • No impact on Operating Line for exporters |

Source: *Financing Trade and International Supply Chains*, Gower, UK (2014), Malaket

14. These four elements can be represented as follows:

1. Payment

15. One of the primary elements of Trade Finance is the enablement of secure and timely payment across borders irrespective of whether buyers and suppliers opt to avail themselves of financing or of significant risk mitigation options.

16. The issue of secure settlement is fundamental to the conduct of international commerce, and a textbook interpretation would suggest that new trading relationships, or relationships involving trade with one or more relatively risky markets, should be conducted through secure mechanisms. The most secure (for both parties concurrently) is a widely utilized Trade Finance instrument: the 'Documentary Letter of Credit'. A buyer and supplier will agree to conduct trade on the basis of a Documentary Letter of Credit in cases where their relationship has not been tested, where trust is not yet established, or in cases where the situation in one (or both) of each actor's markets is such that it might present a risk to the successful conclusion of the intended transaction.

17. In the presence of well-established and trusted trading relationships, perhaps particularly those involving secure markets, trade transactions may be conducted on the basis of less risk-mitigated (and less complex and costly) mechanisms such as 'Open Account' terms, where buyer and supplier simply agree to the transmission of a payment against the receipt of an invoice. There is, however, in every trade relationship a negotiation power imbalance that exposes either side to a certain level of risk. For example, in an Open Account transaction the exporter (i.e. the supplier) bears all the risk of not getting paid if the customer (i.e. the importer) decides not to execute the promise to pay implicit in the Open Account transaction.

2. Risk Mitigation

18. Risk Mitigation is one of the fundamental propositions in Trade Finance and can be enabled through documentary credit. The use of documentary credit usually arises when seller and buyer have not yet developed a robust and trusted trading relationship, or there is instability in the supply chain or the payment cycle.² Although documentary credit does have disadvantages, like the procedural time which is necessary and the cost of putting it into place, it nevertheless allows buyer and supplier to stipulate agreed terms and conditions of payment. Furthermore, this instrument involves a trusted third party— i.e. one (or more)

² See UNECE Recommendation n°12 (ECE/TRADE/C/CEFACT/2011/4), paragraphs 42-43.

banks—to facilitate a careful verification process to see if the terms and conditions have been met before payment is effected and the goods are released to the buyer.

19. Additionally, mitigation of risk can take the form of various types of guarantees or insurance solutions, including political risk insurance, transport insurance, export credit insurance and numerous other variations that enable the successful conduct of commerce in the most challenging markets on the globe.

20. In addition to well-developed and tested risk mitigation structures and solutions, risk mitigation is also available in the form of expert advice from specialist trade financiers who should know about both transactional solutions and regional and market dynamics likely to pose risk to either or both trading parties.

21. In any event, the identification and mitigation of risk is a core element of the value proposition of Trade Finance, allowing the successful conduct of trade in (and with) developing economies, thus linking directly to Trade Facilitation and promotion activities that can be cornerstones of national policy and trade-based development.

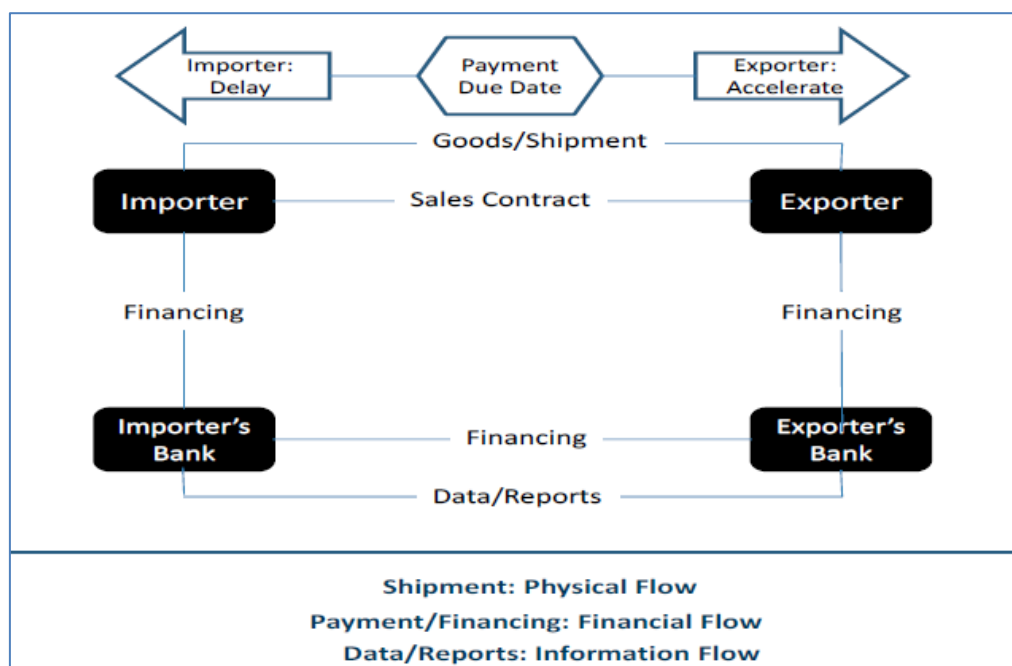
22. The matter of risk, and the credibility of banks involved in international Trade Finance, is central to the conduct of international commerce. In developing and emerging markets the role of export credit agencies (often public sector institutions) is complemented by programs and activities undertaken by the various multilateral development banks (commonly referred to as international financial institutions, or IFIs). The Trade Finance programs of these IFIs have been critical in assisting developing market banks to engage effectively in the global Trade Finance business, and have notably provided various forms of support without incurring any losses.

3. Information

23. Trade Finance, through the leverage of technology, the use of networks that secure prompt and secure communication, the support of intermediating parties such as banks and technology providers, and the leveraging of numerous web-based resources and portals can enable a flow of transaction-related status information.

24. The state, condition and location of a shipment, the status of an anticipated payment, or the status of document verification processes (that will ultimately determine when payment is effected) represent examples of key information that can flow between trading partners, bankers, insurers and other interested parties about the business being conducted (see figure 2).

Figure 2: Needs of Buyers and Suppliers: Physical, Financial and Information Flow



Source: OPUS Advisory Services International Inc.

25. The pace of commerce, including international trade, has so accelerated that parties across global supply chains increasingly demand access to near real-time information about any number of aspects of the transactions in which they are engaged. Technology has evolved in its functionality and capabilities in ways that begin to address those needs, and further fuel expectations of what will be possible in the near future. Timely information and rich data is of interest to trading partners, regulatory authorities, financiers, law enforcement, intelligence officials, and numerous other stakeholders in trade and in cross-border supply chains.

26. While information flow might have been considered secondary or incidental to the trade transaction some years ago, the reality today is much different. Data flows, transaction status and the tracking of related financial flows are integral to Trade Finance. Similarly, the exchange of information flows is increasingly central to the solution offerings of Trade Finance providers.

4. Financing

27. Financing, like risk mitigation, is central to the value proposition of Trade Finance and can benefit trading parties, potentially one or more banks, and any number of actors that participate in the supply chain that links a buyer and a supplier.

28. Financing, simply put, is the lending of funds for the purpose of enabling the conduct of business (in this case, international trade). A supplier may be in need of pre-shipment financing in order to source components of production, or to fund the transport of the final product to its destination; whereas a buyer may seek financing that enables the purchase of the goods, with such a loan repaid from the proceeds of sale of the goods after they have been received.

29. There are many points in the lifecycle of a trade transaction at which a financing option or solution can be offered to one or more parties. Some options are linked to specific steps or phases of a trade transaction, such as the issuance of a commercial invoice, or the transfer of ownership between supplier and buyer. Financing can also be provided against a receipt evidencing that the goods are held in a trusted/secure warehouse facility and can remain accessible to the lender until repayment is made. The same notion of linking financing options or solutions to specific events in the lifecycle of a transaction or relationship applies in the context of cross-border or global supply chains.

30. While financing was less critical for a number of years prior to the 2008 global crisis (when the global economy was awash in excess liquidity) the post-crisis realities are such that the ability to include a financing package with an export sale is a competitive advantage for suppliers in this highly-regulated and cash-constrained environment. Additionally, financing can be attractive if it can be secured through Trade Finance mechanisms in jurisdictions where the availability of credit is greater, and thus the cost of financing is materially lower. SMEs based in developing economies, for example, are challenged not only due to limited availability of financing but also by the reality that, whatever financing is available, it is often prohibitively expensive.

31. There also an option for a supplier or a buyer to arrange financing under a Documentary Letter of Credit on the basis of a draft which represents the payment obligation under that letter of credit. Documentary credits are often issued on the basis that the supplier will receive payment at some agreed future date, for example 90 days after shipment, or 120 days after sight (i.e. examination and approval of the documents by a bank). In such cases, a supplier may prefer to obtain payment immediately and would seek to do so by having a bank discount the draft and remit monies today through a loan with repayment of the loan to take place when the obligation comes due. Similarly, a buyer can delay the point at which it remits payment by arranging for a bank to pay the supplier, but only seek reimbursement from the buyer at some agreed future date.

IV. Supply Chain Finance

32. In the past five years one emerging view has been that Trade Finance ought to be understood to be a subset of Supply Chain Finance (SCF). Supply Chain Finance is a series of practices and technologies that support the financial processes of an end-to-end supply chain. One of the functions of Supply Chain Finance is to align the execution of Trade Finance instruments with the actual movement of goods and payments along the supply chain. What is clear is that traditional Trade Finance mechanisms most commonly involve trade on a bilateral basis (between one buyer and one supplier) while Supply Chain Finance aims to look at trade more holistically, in terms of the ecosystem of commercial relationships that make up an international or global supply chain.

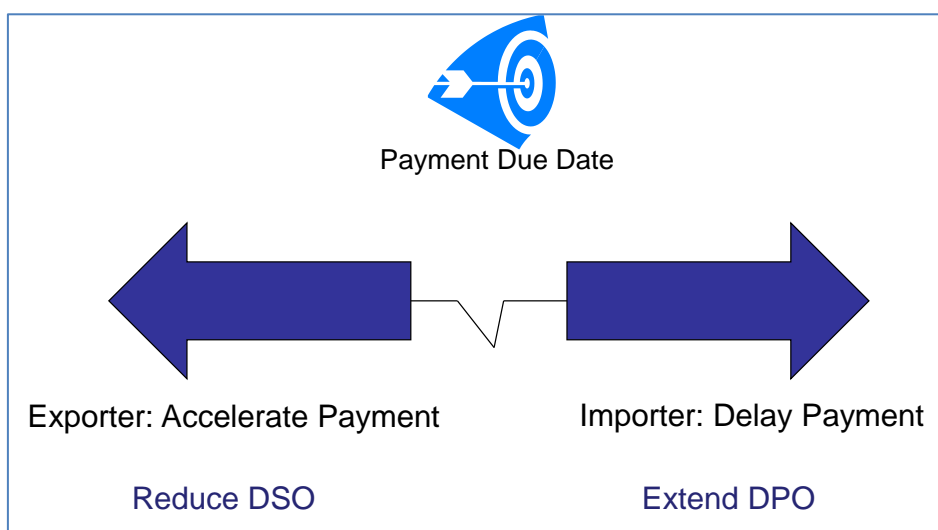
33. Advances in information technology and in Trade Facilitation business standards are generating a shift to trade on Open Account terms. This has compelled the banking industry to re-engage with buyers and suppliers by developing a value proposition aimed at meeting the needs of traders operating on these Open Account terms. It has also led to the development of Supply Chain Finance in complementing the known Trade Finance methods.

34. While some argue that Supply Chain Finance is largely a collection of long-established banking and finance mechanisms, the innovation in Supply Chain Finance is less in the components that comprise it, and more in the way it motivates companies and banks to look at international commerce as an ecosystem of commercial relationships that cross borders, with major buyers developing supplier communities that could number in the tens

of thousands. Supply Chain Finance is evolving quickly and is, without doubt, the high-growth and high-potential area in the financing of international commerce

35. Supply Chain Finance is typically based on the financing of payables, receivables, or inventory, and can offer financing and working capital solutions to buyers and/or to their suppliers, enabling positive impact for each group on Days Sales Outstanding (DSO), Days Payables Outstanding (DPO), and Days Inventory Outstanding (DIO)³. Parties involved in trade relationships have opposite objectives: the buyer tends to delay payments as much as possible to keep cash at hand, while the supplier wishes to be paid on time and (when cash is needed) even earlier than the payment due date. Both wish the other party to hold inventory. Supply Chain Finance schemes can avoid this inevitable tug-of-war (see figure 3).

Figure 3: Supply Chain Finance for Buyers and Suppliers

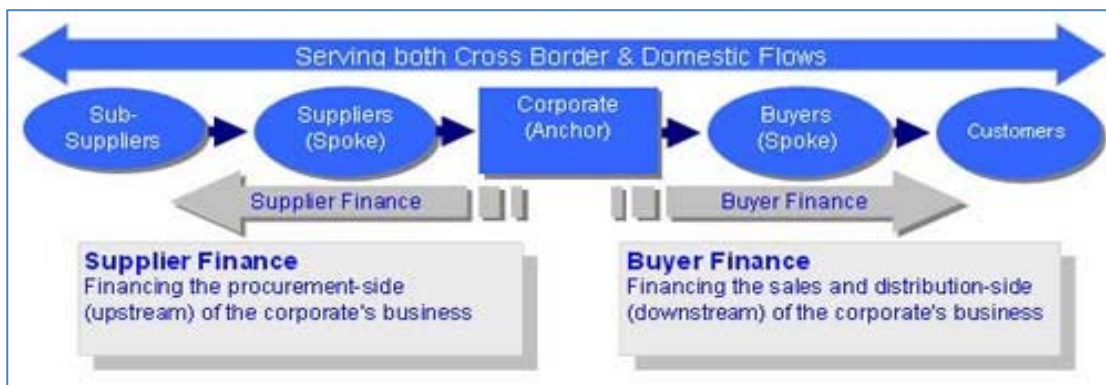


Source: OPUS Advisory Services International Inc.

36. As with traditional Trade Finance, Supply Chain Finance can offer pre- and post-shipment financing options (see figure 4) and can enable access to affordable financing in markets and/or to parties where financing would otherwise be very expensive or simply unavailable. Inventory Finance solutions are subject to national legal and accounting regulatory controls and limitations, and therefore will not be the focal point of this paper.

³ <http://www.investopedia.com/articles/06/cashconversioncycle.asp> (Accessed 28 March 2017).

Figure 4: Scope of Supply Chain Finance

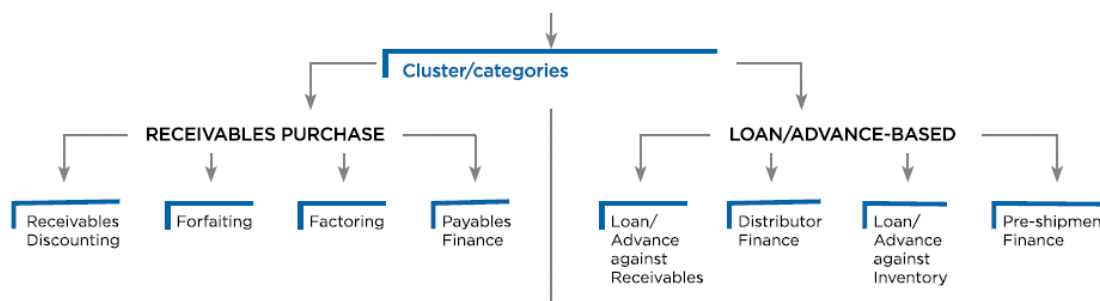


Source: Standard Chartered Bank (Website)

37. Given the nascent nature of Supply Chain Finance, some providers might offer one or two products or solutions, while the leading players possess a suite of end-to-end solutions aimed at all parties in a supply chain including (among others) logistics, customs and insurance providers.

38. An initial list of the financial instruments that constitute the Supply Chain Finance portfolio is provided by the International Chamber of Commerce Banking Commission which is leading the Global Supply Chain Finance Forum—a global initiative in collaboration with several industry associations—to develop such a set of definitions to benefit clients, regulatory authorities, service providers (e.g. accountancy and audit firms) and others (see figure 5).

Figure 5: Supply Chain Finance Techniques and Definitions

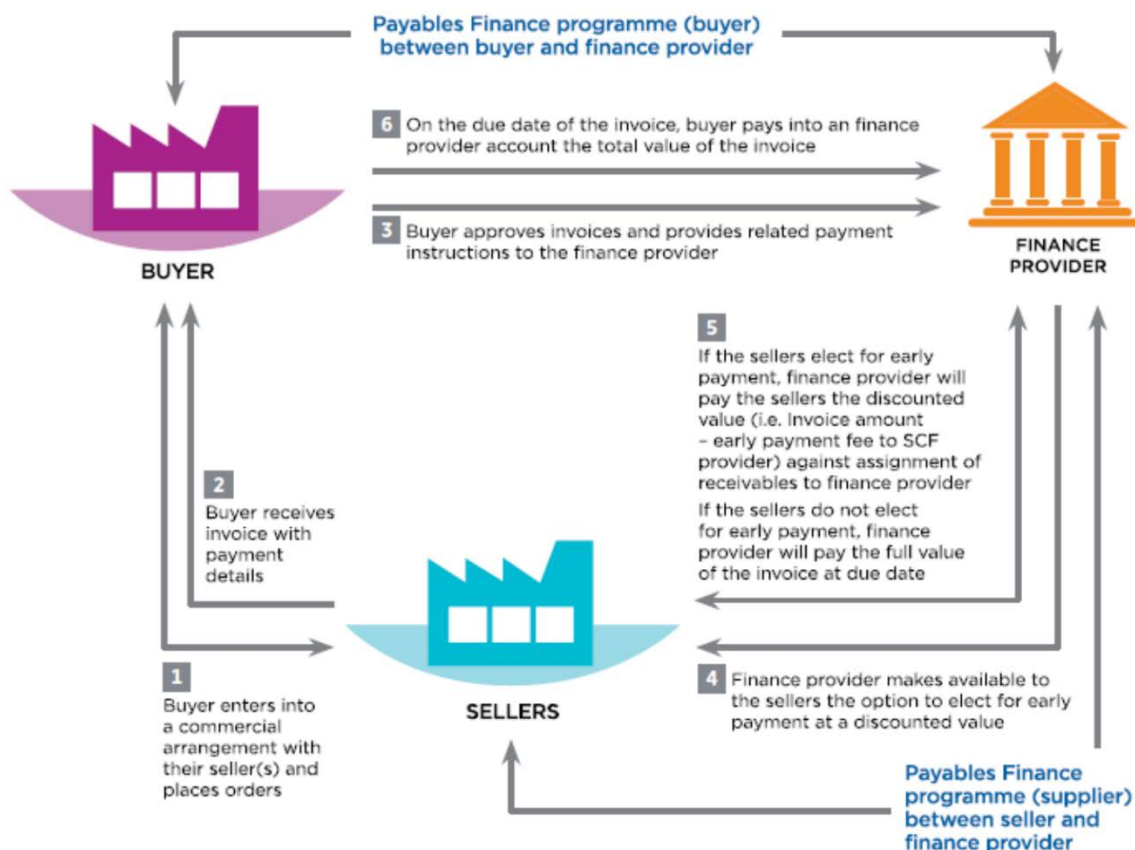


Source: Global Supply Chain Finance Forum, 2016

39. Payables Finance is one of the most common offerings in Supply Chain Finance today. In this structure, a large buyer and the buyer’s bank agree to put in place a financing program aimed at a qualified subset of suppliers of the buyer in question. These are often those considered to be ‘strategic suppliers’, but also perhaps suppliers with a minimum monthly turnover of business with the buyer (e.g. SMEs). As soon as the invoice received by the buyer is approved for payment, the supplier can present the approved document to the bank and receive an advanced payment, minus the service and the discount fee. This fee will be lower than what the supplier would otherwise get from the bank. This feature represents the key of the Payables Finance scheme: the supplier has strategic relevance to the buyer so the buyer will inform its financial institution that, whenever that supplier will present an approved invoice for discount, a special fee will be applied based on the assurance that the buyer—

usually a credit-worthy client of the bank—will honour the debt and refund the bank at payment due date. Thus, the bank has certainty of being repaid and can lower the risk (measured with the interest fee) attributed to that supplier (see figure 6).

Figure 6: Payables Finance Process Flows



Source: Global SCF Forum

40. This technique of Supply Chain Finance works because the buyer recognizes the importance of maintaining a robust supply chain and decides to leverage a strong credit standing and significant borrowing capacity to provide financing to (selected) suppliers through the buyer's bank.

41. Suppliers, many located in developing and emerging markets, given prevailing commercial practices and sourcing patterns, ultimately see value in these Supply Chain Finance programs as a means of accessing affordable liquidity through a channel that does not impact their (limited) borrowing capacity, balance sheet, or even require them to be 'bankable' or technically capable of putting together a loan proposal to a local lender.

42. Suppliers can benefit also from other Supply Chain Finance instruments such as Factoring. A factoring house, or factor, is a bank or specialized financial firm that performs financing through the purchase of invoices or accounts receivable. The factor purchases the supplier's short-term accounts receivable for cash at a discount from the face value. The factor also assumes the risk on the ability of the buyer to pay, and handles collections on the receivables. Thus, by virtually eliminating the risk of non-payment by buyers, factoring allows the supplier to offer open accounts and improves liquidity positions.

43. Production processes encompassing manufacturing, warehouse and inventory management, and material handling also fall under Supply Chain Management's control. Inventory Finance is a Supply Chain Finance instrument provided to a buyer or seller for the holding or warehousing of goods, and over which the finance provider usually takes a security interest or assignment of rights and exercises a measure of control. The incidence of the financing need will depend on the structure and timing of the manufacturing and delivery cycles deployed along a particular supply chain.

44. It becomes quite evident that Supply Chain Finance programs provide a clear illustration of their multi-party nature, in contrast to Trade Finance mechanisms that are aimed at meeting the needs of one buyer and one supplier. The demand for Supply Chain Finance is growing significantly, both through the increasing engagement of banks, export credit agencies⁴ and international institutions, and through market entry by non-bank providers.

V. Linking Trade Finance and Supply Chain Finance to Trade Facilitation

45. The primary goal of Trade Facilitation is to help make trade across borders (imports and exports) faster, cheaper and more predictable, whilst ensuring its safety and security. In terms of focus, it is about simplifying and harmonizing formalities, procedures, and the related exchange of information and documents between the various partners in the supply chain. For the United Nations Economic Commission for Europe (UNECE) and its United Nations Centre for Trade Facilitation and Electronic Business (UN/CEFACT), Trade Facilitation is "*the simplification, standardization and harmonization of procedures and associated information flows required to move goods from seller to buyer and to make payment*". Such a definition implies that not only the physical movement of goods is important in a supply chain, but also the associated information flows⁵.

46. Often activities promoted and conducted under the overall heading of Trade Facilitation focus on the management of custom procedures. Although Customs are a key player in Trade Facilitation, focusing on these agencies and their processes alone is not sufficient. Trade Facilitation has to encompass the entire trade environment, actors and processes involved in a transaction. An international supply chain perspective should be adopted.

47. A supply chain embraces all activities necessary for goods to be produced and delivered to the final consumer. Such activities include sourcing of raw materials, preparing for transport, requesting an import licence, preparing documentation for customs, clearance, payment, and delivery to the consumer. At a minimum, a supply chain involves two parties: the seller and the buyer. In reality, a supply chain involves many different parties.

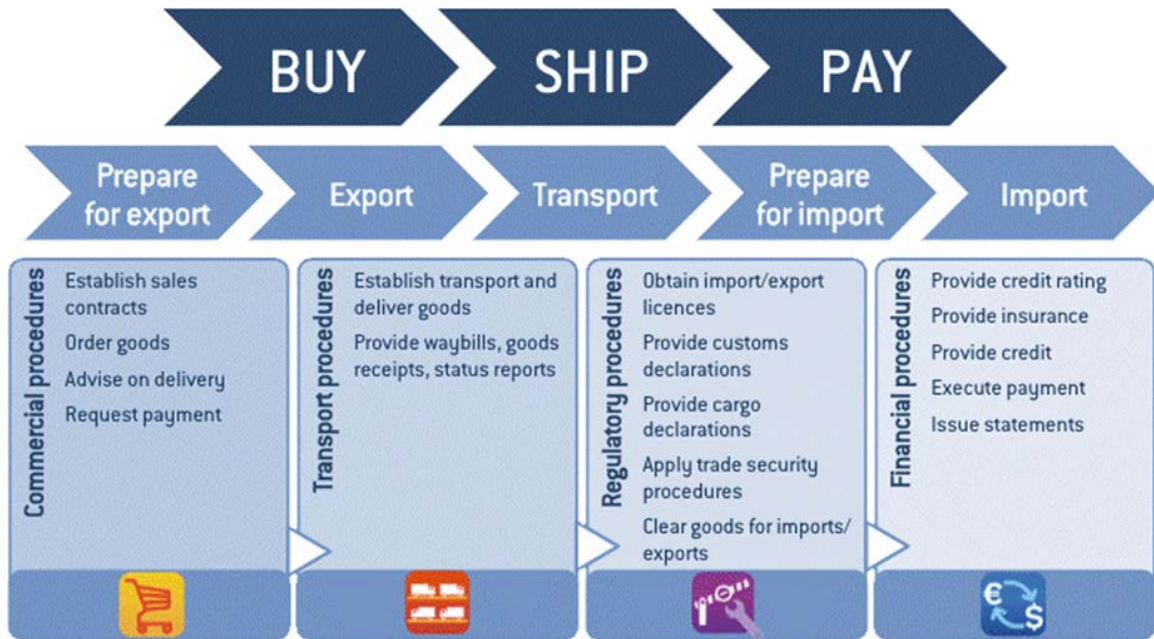
48. Trade Facilitation experts present the practice of facilitation in terms of a model termed "Buy-Ship-Pay"⁶ (see figure 7).

⁴ <http://www.investopedia.com/terms/e/export-credit-agency.asp> (Accessed 28 March 2017).

⁵ <http://tfig.unece.org/details.html>, (Accessed 28 March 2017).

⁶ <http://tfig.unece.org/contents/buy-ship-pay-model.htm> (Accessed 28 March 2017).

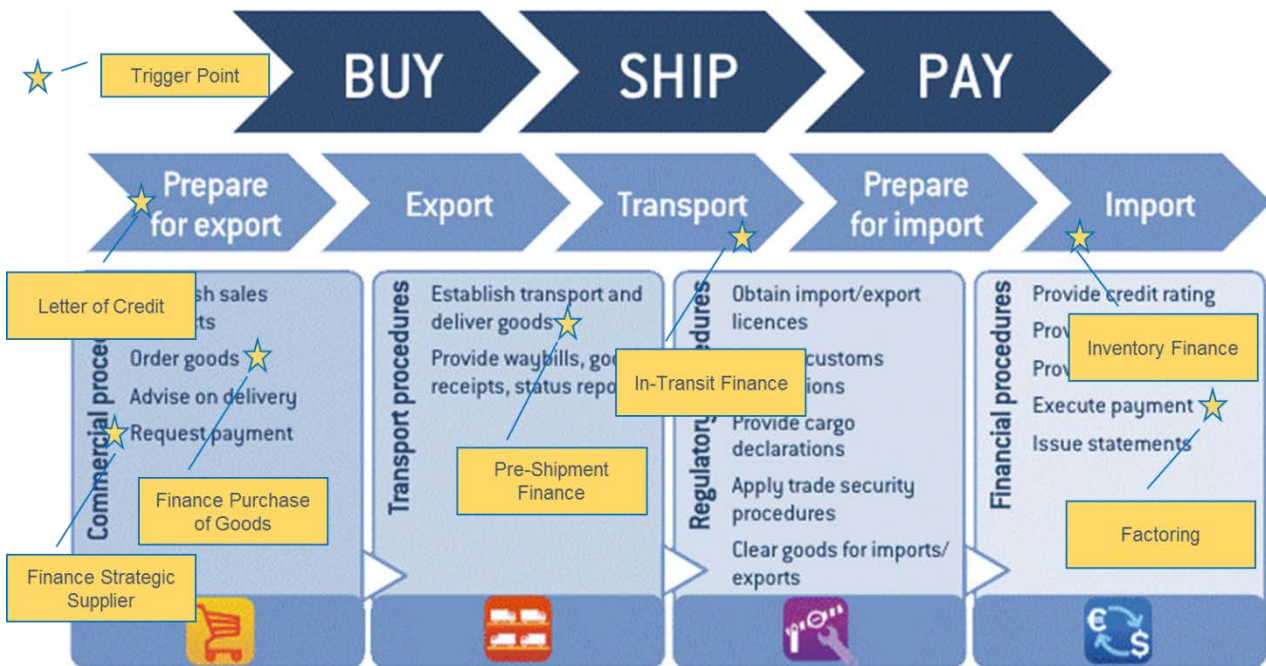
Figure 7: The Buy-Ship-Pay (BSP) Model



Source: UN/CEFACT International Supply Chain Reference Model

49. Financing tends to be considered as mostly related to payments of the core activities of the BSP—with receivables and payables-related financial instruments apparently out-of-scope—although the model elements present linkages to the events that can trigger a financing solution (or proposal) for a buyer, supplier, bank or other member of an international supply chain (see figure 8).

Figure 8: The Buy-Ship-Pay Model Triggers Financing Opportunities



Source: Camerinelli, UN/CEFACT International Supply Chain Reference Model

50. It is worth noting that the logical clarity and ‘neatness’ of the Buy-Ship-Pay model indirectly implies the wide range of potential events which can trigger a financing proposition. Such events can arise at any stage of a trade transaction: from the very earliest negotiation, when a supplier can offer competitive terms to a buyer; during sub-assembly of goods under production through to post-shipment (when a buyer might need financing) until the goods are received and sold to an ultimate client, and revenue is collected accordingly.

VI. Conclusions

51. Supply chain performance in a particular jurisdiction that wants to pursue international sales is linked to the availability of financial support—especially when it involves SMEs. Many jurisdictions, from developing to so-called advanced economies, acknowledge trade as a key driver of economic growth and value-creation.

52. Trade Facilitation should dedicate more attention to the receivables, payables, and inventory financing aspect of international trade. The core proposition, and a fundamental message of this paper, is to propose that Trade Facilitation ought to extend proactively to include attention to the dimension of Trade Finance and Supply Chain Finance.

53. In our opinion, there is scope to provide elements for developing the inclusion of Trade Finance and Supply Chain Finance into Trade Facilitation. In order to further explore this possibility, we propose to consider the creation of a project, led by Trade Finance, Supply Chain Finance and Trade Facilitation experts, ideally capable of producing—as an outcome—a Recommendation to integrate Trade Finance/Supply Chain Finance as enabling tools for Trade Facilitation.

54. The proposed UN/CEFACT project that this paper encourages to launch, should undertake qualitative and quantitative analysis around the opportunities and the value-creation that will flow from integrating (i.e. bridging) financing into Trade Facilitation activity, and to do so concurrently from the perspective of Trade Facilitation practitioners and Trade Finance/Supply Chain Finance experts.

VII. References

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