INTERNATIONAL CHAMBER OF COMMERCE
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Memo to: G20 Governments, Central Banks and International Financial Institutions

PRIMING TRADE FINANCE TO SAFEGUARD SMES AND POWER A RESILIENT RECOVERY FROM COVID-19

1. Trade finance: an essential but increasingly vulnerable asset class

1.1 Trade finance plays a central role in the real economy, underpinning an estimated 80–90% of global trade, and is a proven low-risk asset class.[1]

1.2 The global trade finance market in recent years has proven extremely vulnerable to economic shocks—such as following the Lehman bankruptcy in 2008. The short-term, transactional nature of trade finance means that supply can retrench sharply in response to perceived risks—with "credit crunches" halting both imports and exports in several Asian and Latin American economies in the 1990s.

1.3 Small- and medium-sized enterprises (SMEs) play critical roles in global trade and are often highly reliant on trade financing but face the greatest hurdles in accessing affordable provision. Prior to the pandemic, over half of trade finance requests by SMEs were rejected, compared to just 7% for multinational companies.[2] What's more, a number of studies have shown that women-owned businesses have even greater difficulties obtaining trade credit, which limits their full participation in the economy.[3]

1.4 It has been widely documented that regulatory changes—including the application of Basel III—have coincided with commercial banks reducing their trade finance business over the past decade. For instance, the number of banks providing trade credit in Africa between 2013 and 2019 has declined by 23%.[4]

2. Market assessment and outlook: major downside risks to supply following the "Great Lockdown"

2.1 A range of "stress signals" have emerged in the trade finance market in recent months which appear to mirror trends that preceded major supply shocks during previous crises, inter alia:

- **Retrenchment of banks** from financing sectors deemed to be "high-risk"—most notably, the exit of major banks from the commodities trade finance market in August 2020;
- **Pricing volatility**, with anecdotal reports of increases in pricing for SMEs;

1 By way of example: default rates between 2008-2018 for import letters of credit averaged 0.36%, and 0.45% for performance guarantees. For further data on the performance history of trade assets, see: International Chamber of Commerce, ICC Trade Register Report 2019 (2020).

2 International Chamber of Commerce, ICC Global Survey 2020: Securing future growth (2020).

3 See e.g.: DiCaprio, Yao and Simms, Women and Trade: Gender's Impact on Trade Finance and Fintech (2020)

4 African Development Bank Group, Trade Finance in Africa: Trends over the past decade and opportunities ahead (2020).

- **A "flight to safety"**, with recent survey data indicating that banks are focusing their trade finance activities on existing multinational clients—and rejecting "almost all" applications from clients without pre-existing relationships and SMEs with weak balance sheets;[5]
- A reported **60% increase in rejected applications** for trade credit insurance in the United States;[6] and
- **Operational disruptions** caused by the reliance of widely used trade finance instruments, such as letters of credit, on hard copy paper documentation.

2.2 Continued uncertainty in the global economy could create a "perfect storm" for widespread retrenchment in the trade credit market in the coming months. Three downside risks are of particular concern:

- First, the weakened balance sheet position of many businesses is expected to lead to a **significant tightening of credit conditions**—particularly for SMEs and firms in industries hardest hit by the pandemic.
- Second, **rising sovereign debt distress** risks accelerating the retrenchment of banks from short-term exposures in emerging and frontier market economies—as seen, for instance, during the Asian financial crisis in the late 1990s.
- Finally, **devaluations of local currencies against the US dollar** have also been shown to significantly constrain trade finance availability.[7] In this context, it is instructive to note that despite US dollar weakness in recent months, many developing countries have seen net depreciations against the dollar since the start of the crisis—likely placing a further drag on access of local firms to short-term credit facilities.

3. The risk of supply shortages to the real economy present a clear case for interventions now

3.1 While ICC welcomed the early actions taken by governments, development banks and regulators to provide support for trade finance in response to the initial impacts of the crisis, we believe there is a clear rationale for additional interventions to mitigate the risk of trade financing gaps inhibiting a post-pandemic recovery.

3.2 ICC estimates that restoring trade to pre-pandemic levels in 2021 will require **an additional US$2 trillion of trade finance** to be delivered to the real economy relative to the level of supply this year. Given the issues noted in paragraph 2, above, it remains highly uncertain as to whether banks will have sufficient risk appetite to power such a rebound.

3.3 While some policymakers have noted that there is no data to indicate a widespread mismatch in supply and demand through the first three quarters of 2020, it is instructive to note that banks are currently relying heavily on public risk guarantee schemes to underwrite new trade exposures despite highly depressed transaction volumes. With utilisation of development bank programmes typically double their pre-crisis levels as of August 2020, we are concerned that the limits of existing public support schemes will be rapidly exceeded once demand for trade rebounds or as stimulus fades from the real economy.

5 AfDB and International Chamber of Commerce (forthcoming).

6 See e.g.: Steinberg and Wallace, Insurance Freeze Snarls U.S. Supply Chains, The Wall Street Journal (22 September, 2020).

7 Bank for International Settlements, Trade credit, trade finance, and the Covid-19 Crisis (2020).

3.4 With many small businesses operating on dwindling reserves in the wake of the pandemic, any shortages of essential financing present an acute risk of accelerating business failures—particularly with many governments now lacking the fiscal space to provide further direct subsidies to local economies.[8]

3.5 Data from the ICC network shows that 53% of small business owners in least developed countries fear their firms will close permanently unless there is a significant improvement in their cashflow position in the next three to six months.[9] Viewed through this lens, there is little room for error in safeguarding the supply of trade finance and working capital to avoid a significant erosion of productive capacity in many economies—and associated spill over effects for global supply chains and consumer welfare.

4. Trade Finance is the best means to provide low-risk stimulus to power a post-pandemic recovery

4.1 With strained public balance sheets limiting scope for further government stimulus measures, trade is expected to be a vital form of relief for many businesses in the wake of COVID-19. In this context, major interventions to prime the supply of trade finance should be viewed by G20 governments as not only means of mitigating downside risks to the economy, but as low- or no-cost means to fuel a rapid and resilient recovery from the crisis.

4.2 Major G20 commitments to support the supply of trade finance/working capital through risk guarantee schemes would carry a relatively low risk to public finances given the proven performance history of the asset class and, moreover, the secured nature of merchandise trade transactions.

4.3 Given that perceived corporate insolvency risks are likely to result in significantly tightened credit conditions for SMEs, we suggest that public guarantees to cover credit risks are likely to be a more effective means of safeguarding the supply of essential financing by commercial banks compared to classic monetary policy interventions to boost liquidity.

4.4 The use of regulatory flexibilities under Basel III to improve the capital efficiency of trade exposures—in line with available performance data—also offers the opportunity to significantly boost provision at no cost to national exchequers. In this connection, we endorse the recent findings of the B20 Trade and Investment taskforce that applying conservative changes to the capital treatment of trade assets under Basel III could enable the incremental supply of US$2.4 trillion in trade finance to the real economy.

5. An agenda for action

5.1 There is a clear business case for proactive interventions to ensure the trade finance market is primed to support a rapid recovery from COVID-19.

5.2 Based on extensive consultations with financial institutions and businesses throughout ICC's global network, we appeal to G20 governments to commit to coordinated action of sufficient ambition and scale to enable cross-border trade to provide genuine relief to businesses and workers. Such an agenda should encompass:

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8 On the stimulus gap in emerging markets, see e.g. International Labour Organization, COVID-19 leads to massive labour income losses worldwide (23 September 2020).

9 UNCDF, Columbia University and the International Chamber of Commerce (forthcoming).

– Enacting emergency legal reforms to **allow digital documents to be used in the processing of transactions**—following the lead taken by a number of governments in recent months in phasing out requirements for some trade documents to be presented in hard copy;

– **Utilise flexibilities in the application of Basel III to trade financing** to free up bank capital to support SME transactions at scale;

– Consider **large-scale government/central bank purchases of trade assets**—for instance, through securitised vehicles—to free up bank balance sheets to finance new transactions;

– Ensure **export credit agencies are sufficiently capitalised** to provide adequate support for short-term trade transactions—with appropriate transactions limits and no artificial restrictions on geographical coverage;

– Significantly **scale the capacity of development bank schemes** to provide risk mitigation and liquidity at levels commensurate with the anticipated needs of the real economy; and

– **Mandate development banks to take on greater levels of risk** to provide counter-cyclical support for SME transactions for the duration of the crisis.

5.3 We also recommend that G20 governments encourage the WTO to play a more active role in finding policy solutions to trade financing gaps given the systemic importance of short-term credit to world trade.