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ADB offers new means to lift Asean trade levels

The development bank will launch a new trade support initiative later this year in collaboration with leading international banks to offer supply-chain financing to small companies.

By Paolo Danese 07 Apr 2014

The central bank governors from the Association of Southeast Asian Nations (Asean) were set to sit down together on April 4 for their 18th Asean Finance Ministers' Meeting being held in Myanmar.

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While the group had plenty of items on the agenda, one topic would have been of interest to them all: exactly how can Asean bolster trade activity, just over 18 months before their region becomes one free-trade area?

The Asian Development Bank (ADB) thinks it may have part of the answer.

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Asia's multilateral lender intends to launch a supply-chain finance programme later this year to bolster trade volumes in the region. The initiative, set to support more than $1bn in supply-chain finance over the next three years, will further the goals of its trade-finance programme, and will entail the ADB offering financing directly to corporates.

The concept of supply-chain finance is to improve the flow of capital between buyers and suppliers down entire production chains. In essence, small suppliers tend to leverage off the stronger credit profiles of larger buyers. Such leveraging allows banks to provide them with quicker payments and cheaper rates.

The ADB's interest in supply-chain finance and trade finance in general stems from its belief that a gaping hole exists between the financing needs of Asian small and medium enterprises (SMEs) and the amount they are receiving from existing lenders. In a 2013 survey, the institution estimated that a lack of appropriate trade financing had led to a loss of $425bn in growth and jobs creation in developing Asia. Its new programme is designed to plug some of this.

"Our trade-finance programme only assumes bank risk, while the new supply-chain finance programme will assume commercial non-bank risk, enabling us to provide support for open account transactions," says Steven Beck, head of trade finance at the ADB. "We anticipate a start by the third quarter this year, we have signed an agreement with Standard Chartered and we are in the process of implementing that. We have another agreement coming in the next few weeks."

The ADB's strategy is to partner with other banks to tap into their experience in trade and supply-chain finance, while its support helps them reach out to SMEs that they might well otherwise overlook. For the ADB it is an opportunity to both gain expertise in a new area of

business and work to fill some of the gaps it has identified in the market.

The programmes particularly target emerging markets in Asia, but it's in the countries of South-east Asia that they may have the most impact. Conducted effectively with the support of regional and local banks, these programmes could bring wealth and opportunity to businesses in some of the region's least financially developed countries.

That would be a welcome development ahead of the launch of the Asean Free Trade Area in 2015.

Regional experiment

Asean turns 47 this year, yet in many ways it is just entering adulthood.

The association has set the end of 2015 as its deadline for the creation of the Asean Economic Community, a free-trade area linking the 10 country members in an increasingly coordinated political-economical entity. The member countries have not yet formally declared their interest in forming a single-currency zone like the European Union, but they do want to establish a single market within Asean by abolishing tariffs on material goods, as well as facilitating the free movement of people and capital.

"Asean is experiencing something like the 30 years of strong growth after World War II in Europe," says Damien Duhamel, managing partner at Singapore-based advisory firm Solidiance.

Asean certainly has a strong economic wind at its back. The region is predicted to enjoy 5% economic growth this year after averaging 4.55% between 2008 and 2012, according to Credit Suisse. Such growth is supported by strong demographics, with the same study projecting labour-force growth rates of 1.58% for the 2010-2015 period. This trend sets Asean apart from a number of other Asian markets, including China where labour-force growth is already starting to flatten and is set to be on a declining spiral from 2025, according to a KPMG study.

The substantial growth is accompanied by exploding levels of trade. A recent study by Swift indicates that by 2020 60% of world trade will have an Asian "leg". Intra-Asean growth is also sustained, with member countries already conducting 25% of their total trade within the association.

"We are just at the beginning of the intra-Asean trade boom," says Duhamel.

The region's financial institutions are all engaged in this transformation, eager to expand throughout a fast-growing region of 600m people, many of which lack access to a full array of banking services.

Yet despite this opportunity, no regional bank has succeeded in offering pan-Asean services, particularly in the field of trade finance. It's a failure that is, in large part, down to persisting structural problems.

A paper published in February 2014 by the ADB Institute's director of research Ganeshan Wignaraja pointed to four key gaps in Asean that hinder better trade integration: cross-border infrastructure, insufficient use of existing free-trade agreements (FTAs), barriers to physical trade, as well as limitations to the free trade of services.

An important factor underlying such shortcomings is the limited availability of capital. A lack of ready funds doesn't usually affect large-scale investments such as physical infrastructure projects, because such projects tend to receive some degree of government backing. Neither is

the funding gap identified by the ADB particularly problematic for large multinationals, whether Asian-based or not, as international banks, in particular, tend to be eager to offer them the financing they need.

The impact is felt much more by SMEs, which still find it difficult to get adequate financing with both local and international banks to support their supply-chain needs when engaging in cross-border trade.

“Anybody can have a credit card, but no SME can get a credit card in the region. Banks have not pursued SMEs decisively enough,” says Duhamel.

Regulatory restraints

Bank reluctance to chase such clients is understandable. “Distributor finance is riskier than traditional trade finance [in Asia],” says Shirish Garg, director, transaction banking, Standard Chartered.

Supply-chain finance often involves lending to fairly small companies, which are inherently vulnerable. Distributor finance, which targets the typically small retail businesses that purchase products from larger buyers to sell locally, is even riskier, as these companies are small and banks cannot lean on the credibility of the larger-scale buyers to offset these risks.

The implementation of Basel III has further reduced the risk appetite of financial institutions, which find themselves torn between supporting high-potential, yet riskier, smaller companies, and the need to ensure compliance with capital requirements and other rules.

The regulations extend well beyond Basel III. Many banks cite the difficulty in evaluating companies in emerging-market jurisdictions from an anti-money laundering perspective or according to other watchlists, such as the US’ Foreign Corrupt Practices Act. Myanmar is the clear example here, where trade sanctions by the US have yet to be entirely lifted, leaving the banks as observers and advisers to local governments without being able to provide financial support to local companies.

When a choice has to be made, banks will usually favour high-quality credits first, says Parvaiz Dalal, managing director, head of structured trade, commodity financing and asset distribution for Asia-Pacific at Citi.

Because of this, “global giants come first and receive preferential treatment [by the banks]. Ninety percent of the SME segment may still be left out. Banks are trying to help them with more credit by offering a variety of financing options like supplier financing and, at the same time, creating more credit capacity by participating in programmes offered by various institutions such as the supply-chain finance programme financing by the IFC (International Finance Corp.) and the ADB,” Dalal says.

Mritunjay Singh, head of supply-chain finance, transaction banking, Standard Chartered, agrees that banks are trying to expand the spectrum of their involvement in their clients’ supply chain as much as possible.

“Supply-chain finance has moved away from being buyer-led to becoming now an end-to-end evaluation of how the corporate supply-chain works, from procurement to warehousing to distribution,” adds Garg.

Receivables wrangling

Another issue is that the regulations surrounding the sale and transfer of receivables are still at early stages in most of Asia. This hinders the ability of financial institutions to properly evaluate their risks and, therefore, to provide value to SMEs on their receivables base.

“While the supply-chain finance and receivable financing solutions have seen a significant uptake in recent years in Asia, the matters relating to terminologies used, regulatory and legal requirements are not yet standardised,” says Vijay Vashist, global head of open account trade and supply chain, DBS.

From a legal perspective, the lenders need to understand and be clear on the treatment of receivables in the borrower’s jurisdiction and establish whether the sale of receivables represents a sale and purchase, or a form of short-term funding. It’s an important difference as it will impact the lender’s recourse on an insolvency, says Jolyon Ellwood-Russell, a structured trade and receivables finance partner with law firm DLA Piper in Hong Kong.

In common-law jurisdictions, transactions involving receivables are usually structured as a purchase, thereby protecting priority. However, certain commercial features can lead to the transactions being re-characterised as a loan instead of a purchase.

This results in the lender becoming an unsecured creditor, a risk lenders need to be aware of. If a lender is looking to recover from a debtor directly, there may be laws protecting the debtor or other third parties in a local jurisdiction. This means a financier always needs to be aware of any collect-out route and be familiar with the jurisdiction in which he will operate.

For the new ADB initiative to succeed, it will be crucial to ensure clarity and enforceability on the liabilities arising from the sale of receivables across the diverse jurisdictions where buyers and sellers may be based throughout the region. While banks have been used to supply-chain finance involving blue-chip companies based in the US or Europe, providing the same products across emerging markets won’t be easy.

ADB efforts

The ADB is embarking on a multi-pronged approach to mitigate some of these restrictions.

As a start, it is finalising preparations ahead of the launch of the supply-chain finance initiatives. “We are ramping up capabilities for corporate evaluation – we will be assessing companies and monitoring risks on these companies,” says Beck.

The ADB’s intention is to cooperate with a number of regional and international banks to provide more than $1bn in supply-chain financing. Beck anticipates that the new programme will extend support to over 600 SMEs in the ADB’s developing member countries.

The ADB’s experiences from its first efforts will help it decide whether to expand the programme and experiment with innovative ways to support SMEs in the region.

For now, the ADB will “focus on markets where the gaps are largest”, trying to address the two largest issues preventing SMEs from getting the support they need: weak financials and insufficient collateral. The two factors make it hard for commercial banks to take the risk and too expensive for them to monitor the companies.

Solutions to those issues include reverse factoring, whereby banks can use the credit rating of a large buyer to provide financing to a number of its smaller suppliers. Working with commercial banks to provide this type of solution will benefit SMEs, making credit cheaper and easier to access, says Beck.

Additionally, the ADB is lobbying regional governments to improve its regulation of company receivables.

“The ADB is in contact with governments throughout the region to encourage and provide assistance on how to enhance the regulatory environment,” says Beck.

The institution is also working with the Asia-Pacific Economic Community, in which Asean has observer status, to finalise a second study on trade-finance gaps in the region.

“As part of the second study, we are quantifying the gaps and their impact on growth and jobs creation, as well as identifying causes of the gaps and impediments to financial institutions and banks to provide financing needed to increase trade activity,” says Beck. “We will then […] make suggestions to Asian governments to close some of these gaps.”

Building alliances

The trade-finance initiatives of development banks have been successful in the past because their agendas and interests align well with the desire of private banks to share some of the risk of gaining exposure to companies from new markets at a time of increasing regulatory pressure.

Local banks can often support SMEs on a purely local basis, but they struggle to keep doing so once these companies become involved in cross-border trade. Only international banks, with their broader infrastructure, can offer cross-border supply-chain finance services to these companies.

“Banks need to have good internal IT infrastructure and invoice-processing procedures to offer a good product. They tend to be very IT dependent and so a good IT platform often makes the product attractive for the banks’ customers,” says Ellwood-Russell.

Of course, it could prove costly for international banks to extend their infrastructure further to encapsulate the risk offered by SMEs beginning to trade from emerging countries. This is a potential issue for the ADB’s new programme: for its supply-chain initiative to work it needs the support of international banks, and they may well need to be persuaded to extend their IT and risk-management infrastructure to more cash-strapped local companies.

The development bank’s strategy to team up with private banks with existing expertise will certainly help, but it could still restrict the ADB’s ability to assist as many SMEs as it would like.

International banks might be able to work around this by broadening the scope of their own collaborations with local banks. Such alliances make sense; the international bank has the distribution network and multiple markets coverage, whereas local banks have stronger on-the-ground presence.

One way the two can cooperate is for the international banks to receive risk-mitigation instruments such as letters of credit, standby letters of credit or bank guarantees from the local banks. “Based on those instruments, we as a bank can help the SME segment by giving financing from an offshore location, which is much cheaper,” says Dalal.

The need for additional financing remains very much a priority for swathes of small but growing companies across South-east Asia. These corporates may not boast amazing credit profiles, but they play an integral role to regional economic growth and the productivity of other small suppliers in the region.

The myriad individual challenges these companies face in each Southeast Asian country cannot be solved quickly. But development banks, private banks and local government will all benefit if they can work closely together, and begin taking down some of the roadblocks that these companies face.

The ADB is leading the efforts to break down these blockages. But it will need Asean's private bank players to lend a hand too if the region is to see the sort of increase in trade flows it merits.

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