2 TRADE DIGITALIZATION AND FINANCING: NEW HOPE FOR MSMES?

2.1 AN UNMET NEED

The International Finance Corporation (IFC), the SME Finance Forum and the World Bank Group estimate the entire MSME finance gap to be close to US$ 5 trillion,[3] hindering the ability of MSMEs to grow. This gap, however, is not due to a lack of available funds. A 2019 report by the International Trade Centre (ITC)[4] indicated that "in 2018 global funds held US$ 1 trillion of cash-in-hand equity capital that was seeking investment opportunities". Of particular concern is the trade finance gap, which disproportionately affects MSMEs. Despite the low-risk nature of short-term trade finance, the trade finance gap alone is estimated at upwards of US$ 1.5 trillion.[5] The rejection rate of MSME proposals for trade finance is 45 per cent. According to the Asian Development Bank (ADB),[6] "among MSMEs initially rejected that sought alternative financing, 47 per cent were unable to find anything appropriate"; this does not include those firms that do not even apply for financing in the first place.

Several key reasons are commonly put forward to explain why MSMEs, particularly those in developing nations, struggle to obtain financing.[7] These reasons include a greater risk profile combined with MSMEs' lack of additional collateral and of the formal documentation required for financing, as well as more complexities for MSMEs when financing cross-border activities, a lack of awareness of financing opportunities among MSMEs, and proportionally high costs of services, due, in part, to a lack of digitalization. When it comes to trade finance, some issues are related to working capital issues and others to trade finance products, with each creating different challenges.

[3]https://www.smefinanceforum.org/sites/default/files/Data%20Sites%20downloads/MSME%20Report.pdf.

[4]https://www.intracen.org/uploadedFiles/intracenorg/Content/Publications/SMECO2019.pdf.

[5]https://www.adb.org/publications/2019-trade-finance-gaps-jobs-survey.

[6]https://www.adb.org/publications/2019-trade-finance-gaps-jobs-survey.

[7]See in particular https://www.intracen.org/uploadedFiles/intracenorg/Content/Publications/SMECO2019.pdf, https://www.wto.org/english/res_e/booksp_e/tradefinsme_e.pdf and https://www.adb.org/publications/2019-trade-finance-gaps-jobs-survey.

2.1.1 ASSESSING MSME RISK PROFILES: A COMPLEX TASK

Many of the challenges facing MSMEs in their quest for financing stem from their general position in the market.

As per one of the interviews quoted hereafter (see Appendix A for a description of methodology), "There is a lack of appetite among banks to provide funding and support MSMEs businesses" [*3 Bank].[8] This is due in part to the perception held by banks that "the rate of default in loans awarded to MSMEs is much higher than large scale businesses" [*3 Bank] and that MSMEs are often not known to banks and lack a credit history.

Lack of collateral may be a problem as well. Banks often require additional collateral to mitigate risks against MSME borrowers with whom they do not have strong existing relations, but this requirement is difficult for many MSMEs to fulfil, leading to increased rejections. As per one financial technology (fintech) company interviewed, "MSMEs often lack the extensive documentation that helps funders understand the risk profile of their business. This means that the little money banks are willing to provide often goes to larger businesses whose risk is easier to calculate" [*22 Fintech]. Assessment of MSMEs' creditworthiness, i.e. risk assessment, is clearly a central issue for MSME financing. It is important to note, however, the difference between good and bad risks. "Some of the US$ 1.5 trillion trade finance gap is good risk, but some of it is bad risk. We need to focus on the good risk. What we need is to improve our understanding of the good risk within that gap" [*30 Bank]. This is also relevant in the context of domestic financing.

In addition to this, "most MSMEs do not have an effective marketing strategy and so have not been able to successfully sell their ideas to funders" [*3 Bank]. Ultimately, this suggests that, because of an inability to communicate successfully with potential funders through actual documentation or comprehensive marketing, MSMEs are inadvertently withholding information from these funders, which negatively affects their ability to acquire the funding. To acquire funding successfully, MSMEs need to articulate their unique benefits while simultaneously providing necessary "know your customer" (KYC) compliance documentation.

One tool that may help in this realm is a digital identification system for companies that permits a legal entity to be identified quickly and unambiguously; such a tool would underpin a global digital identity system.[9] Without a global digital identification system, finding information about an MSME in a sea of metadata is difficult, if not impossible. Such a system would increase transparency and underpin the advantages offered by fintech, allowing greater inclusion of MSMEs in the global economy by facilitating customer onboarding,[10] credit approval processes and the identity validation of potential clients. It would also increase access to finance for MSMEs in emerging markets by making the flow of reliable information about small companies easier.[11]

Recognizing the value of a global identification system for companies, the G20 spearheaded work on a global legal entity identifier (LEI) in 2011.[12] Launched in 2014, the LEI has, however, seen limited adoption, as only 1.8 million companies had acquired an LEI by the end of 2020. Other similar initiatives include the Data Universal Numbering System (DUNS), a proprietary system developed and managed by Dun & Bradstreet that assigns a unique numeric identifier (a DUNS number) to a single business entity, and the Trade Identification Number (TIN) developed by the World Customs Organization (WCO) – not to mention the various DLT-based

[8]Note: Throughout this publication, where quotations are used from interviews or qualitative survey results, they will be cited in this format: square brackets containing an asterisk, an anonymized identifier and categorization of the firm.

[9]Digital identity is a set of validated digital attributes and credentials for the digital world, similar to a person's identity for the real world. A digital identity serves to uniquely identify a person or company. Digital identity fundamentally requires digital identifiers.

[10]Customer onboarding refers to all activities involved in introducing a new business customer to a company.

[11]https://www.adb.org/sites/default/files/publication/505076/adb-brief-109-legal-entity-identifier-tfp-survey.pdf.

[12]The LEI is administered by the Global Legal Entity Identifier Foundation (GLIEF - https://www.gleif.org/en/). It is a 20-digit code based on the ISO 17442 standards, which provides a unique identification to participating parties. Just like a passport or a car registration number, each LEI contains information about companies, such as "who is who", and "who owns whom", and "who owns what". In order to help drive adoption of the LEI, the ICC recently established a working group on mass adoption of the LEI.

initiatives that have flourished in recent years (see Section 3.3.2 on DLT). More recently, the B20 Saudi Arabia, together with Business at OECD, proposed to investigate the feasibility of a global value chain (GVC) passport, which would allow firms to be accredited throughout the relevant GVC as credible partners, and would prove compliance with the relevant financial regulations and requirements, thereby avoiding the burden of having to re-apply for accreditation multiple times across multiple borders.[13]

2.1.2 COMPLEXITIES FOR FINANCING CROSS-BORDER ACTIVITIES

Cross-border activities entail complex risks, particularly linked to foreign transactions and legal procedures. The ADB Trade Finance Gap Survey indicates, for example, that KYC and anti-money laundering (AML) concerns, which become amplified when transacting in multiple jurisdictions, are the eminent reason for rejections of MSME financing and that 20 per cent of trade finance applications are rejected due to a lack of additional collateral. In domestic environments, KYC and AML risks not present include fluctuating foreign exchange rates, higher local interest rates, unfamiliar legal environments, and prudential regulatory and financial transparency risks. Add to these any sort of geopolitical instability or economic uncertainty, and conditions become challenging, at best, for most MSMEs.

According to a WTO report,[14] "many local banks may lack the capacity, knowledge, regulatory environment, international network, or foreign currency to support import-export related finance". As local banks most often serve MSME clients, particularly in developing economies, this may explain why "few banks are focusing on MSME trade finance needs" [*14 Fintech]. This may stem from the complexities associated with financing cross-border activities. While this is the case, cross-border activities cannot be considered in isolation; domestic activities, such as financing domestic trade and transactions, are also important for MSMEs to achieve success in international markets.

2.1.3 LACK OF AWARENESS AMONG MSMES

MSMEs do not possess the same magnitude of knowledge as funders. This affects both their ability to identify potential sources of funding and their level of comfort when pursuing innovative financing methods. One of the bank respondents [*3 Bank] noted that in most cases, "MSMEs are not fully aware of the various government grants and other initiatives to support their type of business" and that they "are not taking advantage of various innovative solutions geared towards supporting MSME business".

Beyond this, even when MSMEs are aware of the options available to them, many still struggle with a lack of understanding of the processes and criteria for acquisition. A fintech respondent [*13 Fintech] relates one discussion during which "the MSME actually drew attention to the fact that, had they known the process upfront in terms of what would impact the decision-making process, they could have addressed these requirements and secured the funding". Not only do MSMEs often lack knowledge of the funding potentially available to them, including alternative financing options, but they can also lack knowledge of what it is necessary to do in order to acquire that funding. One of the fintech respondents [*14 Fintech] points out that, "while MSMEs talk about access to long-term capital, financial institutions talk about debt. The right conversation is not happening. MSMEs are asking for the right thing but from the wrong institutions".

[13] https://www.b20saudiarabia.org.sa/wp-content/uploads/2020/09/Final-B20-Business-at-OECD-on-GVC-Passport-28082020.pdf.
[14] https://www.wto.org/english/res_e/booksp_e/tradefinsme_e.pdf

To overcome this, there is a need to educate and advertise more, and also to simplify and standardize the application process. In light of the COVID-19 pandemic, however, many financial institutions are providing customers with resources to improve their business plans and financing applications with the aim of improving acceptance rates for pandemic-related financial aid. This is a promising step in the right direction.

2.1.4 HIGH COSTS OF SERVICE FROM A LACK OF DIGITALIZATION

Another factor affecting MSMEs' ability to acquire finance is the high cost of service[15] often associated with MSME financing, in particular trade finance, due, in large part, to a lack of automation as a result of a non-digitized environment.[16] "Without automation, manual handling costs will stay too high to serve a big portion of the MSME market" [*9 Fintech]. This is because "the processing costs of trade finance transactions are far too high in relation to low-value or single transactions, the predominant transaction type for MSMEs" [*10 Fintech].[17] This creates an unfavourable situation for MSMEs as they seek out financing, as finance providers are incentivized to allocate their resources elsewhere. A "lack of digitalization of MSMEs together with small loan sizes, can lead to a high cost of service" [*26 Consultant] and subsequently, a low appetite for providing funds.

This same paradigm also applies to access to credit insurance, if the portfolio of debtors is not optimal, for instance if it is too small or concentrated. Most clients of credit insurance companies in short-term trade are MSMEs.[18] Increased digitization can lower costs and create capacity for servicing small firms. From an MSME perspective, striking the balance between complying with new trade agreements and investing in new technologies is a key challenge and distraction when one considers their limited resources and investment.

Results from the ICC Global Survey on Trade Finance[19] also suggest that some of the difficulties experienced by MSMEs may arise due to the banks that serve these firms. MSMEs tend to be served more often by smaller local or regional banks, rather than larger global banks. Smaller local or regional banks tend to be better able to form close relationships with MSMEs and to foster a sense of trust with these clients. The ICC study, however, indicates that it is the local banks that lag behind the most in terms of digitalization. Only 25 per cent of local banks think that digitalization will provide benefits for their operations, and only 55 per cent project any cost savings as a result of digitalization, due mainly to the perceived cost of change weighed against the potential benefits. This is compared to 59 per cent and 90 per cent respectively for global banks. On top of this, less than half of local banks have a digital strategy. This lack of digital appetite in the banks servicing the most disproportionately underfinanced companies contradicts the belief held by 55 per cent of local banks that they are best positioned to service MSMEs in terms of digitalization.[20]

"Electronic documents sit at the uncomfortable intersection of 19th-century legislation and unsophisticated 21st-century operators"

- ICC Digitalisation Working Group

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[15]http://documents1.worldbank.org/curated/pt/995331545025954781/Financing-Solutions-for-Micro-Small-and-Medium-Enterprises-in-Bangladesh.pdf, https://www.oecd.org/finance/G20-OECD-High-Level-Principles-on-SME-Financing.pdf, https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2019/02/11/Financial-Inclusion-of-Small-and-Medium-Sized-Enterprises-in-the-Middle-East-and-Central-Asia-46335Asia (imf.org).

[16]The cost of finance is a combination of intermediation costs, including processing costs, and the level of risk of clients.

[17]It is important to note, however, that trade finance transaction processing costs may be very different according to the financing instrument being used. A letter of credit, for example, is often more expensive to process than receivable financing instruments, due to the number of documents processed.

[18]https://econpapers.repec.org/article/sprweltar/v_3a150_3ay_3a2014_3ai_3a4_3ap_3a715-743.htmsurance (repec.org)

[19]https://library.iccwbo.org/content/tfb/pdf/2020iccglobaltradesurveyvweb.pdf

[20]https://library.iccwbo.org/content/tfb/pdf/2020iccglobaltradesurveyvweb.pdf

From these studies, it seems evident that although digitalization efforts could help improve the service delivery for MSMEs, the challenges that persist have all but eliminated the incentives for local banks to pursue digitalization. As the ICC Digitalization Working Group[21] articulated, digitization and "Electronic documents sit at the uncomfortable intersection of 19th-century legislation and unsophisticated 21st-century operators". This leads to too few cost-effective choices of new technology provision for smaller banks. Technology is often seen as too costly and too futuristic, as a luxury suitable only for large banks, or as an opportunity for new digital banks, but not for local banks in developing countries.

2.1.5 THE COST OF CAPITAL AND BASEL REQUIREMENTS: AN ADDITIONAL CHALLENGE?

There has been debate surrounding the possible unintended consequences of Basel III requirements.[22] These debates led the Basel Committee on Banking Supervision to make several revisions reflecting the low risk of trade finance and improving its regulatory treatment.[23] It is important to note, in this regard, that studies conducted by the Financial Stability Board[24] and the World Bank[25] do not "identify material and persistent negative effects on SME financing in general, although there is some differentiation across jurisdictions. There is some evidence that the more stringent risk-based capital (RBC) requirements under Basel III slowed the pace of SME lending growth at the most 'affected' banks (i.e. those least capitalised ex ante) relative to other banks", but "these effects are not homogeneous across jurisdictions and they are generally found to be temporary. [...] Stakeholder feedback suggests that SME financing trends are largely driven by factors other than financial regulation, such as public policies and macroeconomic conditions".[26]

This conclusion is consistent with the literature on the effects of bank capital regulations and with stakeholder feedback that MSME financing is largely driven by factors other than financial regulation. In spite of this, questions are being raised about how to provide a more favourable framework for assessing MSME credit risk through digital innovations and taking into account new analytics provided by fintech companies in a Basel environment.

Other concerns have arisen from the termination by many international banks of correspondent banking relationships after the financial crisis of 2008-09 and their reduction of overall exposure towards developing countries and MSMEs (de-risking). While some practitioners have become increasingly concerned about de-risking as a possible result of these requirements, where financial institutions have terminated or restricted business and correspondent banking relationships in order to avoid, rather than manage, a risk-based approach, analysis by international financial institutions, trade institutions, multilateral development banks and academics provides a more nuanced picture. De-risking can also be the outcome of commercial decisions by private financial institutions, and of changing market shares in a post-financial-crisis environment.[27] Nevertheless, the boost that beneficial capital weightings could have on MSME lending should not be completely discounted, as some practitioners noted. At the very least, it could form one part of an overall support strategy at local, regional or international levels and could encourage banks to re-examine their approach.

[21]The ICC Digitalization Working Group was established in 2017 by the ICC Banking Commission to coordinate work relating to the digitalization of trade finance (see https://iccwbo.org/media-wall/news-speeches/icc-banking-commission-launches-working-group-digitalisation-trade-finance/ for more information on the Working Group).

[22]Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks (see https://www.bis.org/bcbs/basel3.htm).

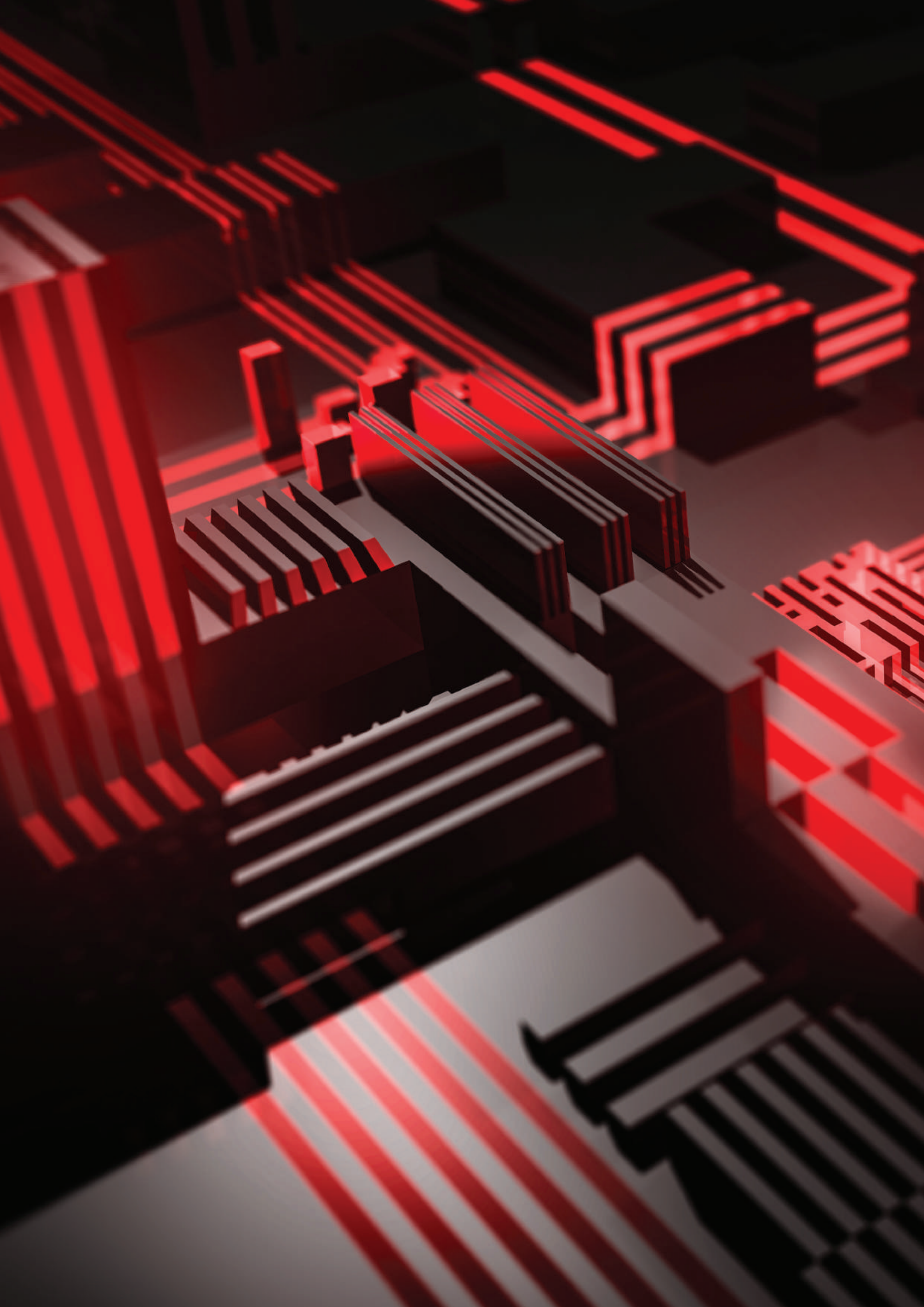
[23]https://www.wto.org/english/res_e/booksp_e/tradefinsme_e.pdf.

[24]https://www.fsb.org/2019/11/evaluation-of-the-effects-of-financial-regulatory-reforms-on-small-and-medium-sized-enterprise-sme-financing-final-report/ edium-sized enterprise (SME) financing: Final report - Financial Stability Board

[25]https://openknowledge.worldbank.org/handle/10986/33011.

[26]https://www.fsb.org/wp-content/uploads/P291119-1.pdf.

[27]http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-Correspondent-Banking-Services.pdf.



2.2 COVID-19: A CATALYST FOR DIGITALIZATION?

There is hardly an industry in the world that has not been impacted by the COVID-19 pandemic. As pandemic-induced closures and shutdowns came into force, many banks and other entities in the finance chain found that they needed to make changes. According to the ICC Digitalisation Working Group's report, *Digital Rapid Response Measures Taken by Banks Under COVID-19*,[28] the largest trade finance process disruptions have been related to the physical transfer of paper documents and negotiable instruments and the requirement for authorized signatures. Largely, these have come about as a result of a lack of physical employee presence at the usual places of business, coupled with the inability to print and transport documents. Operating under "normal" processes has not been an option. To cope, banks have been forced to create or scale up ad hoc digital processes.

According to the ICC Global Survey on Trade Finance,[29] banks have helped customers through the COVID-19 crisis by relaxing many of the rules surrounding financing terms, original documentation rules, and "wet ink" (or manual) signatures. While these are promising signs for trade digitalization, the survey also indicated that many banks have not received significant meaningful support from government authorities to facilitate trade on digital terms.

This lack of governmental support, even in the context of a pandemic-ridden world, is particularly worrisome for the prospects of trade digitalization. This is because, as the ICC Digitalisation Working Group[30] notes, one of the biggest reasons why digitalization has not yet been adopted is the notion that a digitalized process can only ever reap the benefits of its least digital link. If one party in the supply chain, such as a governmental customs authority, still requires physical original documents laden with wet-ink signatures, then the entire process must be at least partly paper-based from the beginning. This has led some firms to question why they should lay out the large capital investment necessary to digitize their processes when their digital work will still be bogged down by paper requirements along the chain.

Nevertheless, the desperate necessity for paperless workarounds has set the industry on a digital course. As the ICC[31] puts it, "the current crisis catalyzes and accelerates a significant reduction (perhaps ultimately elimination) of paper in trade and trade finance transactions".

The impacts of COVID-19 could accelerate a shift in the actual providers of financing.[32] According to the 2020 Dubai Multi Commodities Centre (DMCC) "Future of Trade" Report,[33] "over 80 per cent [of executives at medium to large-sized businesses in the United Kingdom, the United States, and China] were considering switching from traditional banks to alternative lenders for trade finance". If this materializes, this transition could:

*"be a giant leap forward for MSME financing in terms of modernization and growth. A newcomer entering the market would want to streamline the process and make it as simple and cost-effective as possible. As the only way to do this is through technology, this would supercharge the digital transformation of this industry, meaning better processing, better accessibility, better security, and all that for a lesser cost" [*17 Fintech].*

However, who these alternative financiers are, and the extent to which they can aid MSMEs to access finance, including trade finance, remains to be assessed.

[28]https://iccwbo.org/content/uploads/sites/3/2020/04/2020-icc-covid-response-banks-3.pdf.
[29]https://library.iccwbo.org/content/tfb/pdf/2020iccglobaltradesurveyvweb.pdf.
[30]https://iccwbo.org/content/uploads/sites/3/2020/04/2020-icc-covid-response-banks-3.pdf.
[31]https://library.iccwbo.org/content/tfb/pdf/2020iccglobaltradesurveyvweb.pdf.
[32]http://newsletter.itfa.org/not-a-bank-not-a-fintech-the-rise-and-rise-of-alternative-finance-by-shannon-manders-itfa-consultant/
[33]https://www.futureoftrade.com/