Trade Finance, a flywheel effect to boost the economic recovery post COVID-19 pandemic



Contribution to the 2021 G20 process leveraging on the GVC Passport concept: pragmatic recommendations to tackle existing obstacles

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FOREWORD

The COVID-19 pandemic has negatively affected the world's economy. Notably, international trade has suffered during the pandemic, deepening the slowdown of global trade growth faced in the last decade due to both cyclical and structural factors. The latter include rising trade barriers and protectionism, as well as administrative and procedural cross-border inefficiencies. It is now critical to ensure a **sustainable and inclusive economic recovery,** which can only be achieved with reforms that structurally uplift efficiency and productivity for firms.

Policies are most effective if they are complementary to each other and effectively coordinated both domestically and internationally. In order to achieve sustainable economic growth, we need to strive for complimentary policies that aim at inclusive economic growth, productivity and stability as core objectives. "Joining the dots" across policy objectives has been at the core of the joint work between the **B20** and ***Business at OECD*** (BIAC) since 2015, culminating in a series of B20-BIAC-OECD annual events on Finance and Sustainable Growth and related publications led by Gianluca Riccio, Vice Chair of *Business at OECD* Finance Committee. Each year, the conclusions of the roundtables have helped pave the way for action by G20 leaders. Contributions for our publications came from diverse business and employers' federations, SME associations, large corporates, and financial institutions, part of the respective *Business at OECD* and B20 policy bodies. This year, the **IOE** joins the B20 and *Business at OECD* in this effort at the critical time of post-pandemic recovery.

As part of the ***G20 Italy***, **this paper proposes concrete recommendations in support of access to Trade Finance**; it thereby progresses the work on the **"GVC Passport" concept**, initiated under the B20 Saudi Arabia Presidency. The concept provided a thought starter of how to design an authenticated, authoritative, verifiable financial fingerprint of a given entity, enabling it to operate within GVCs without the need to reproduce the same documentation on multiple occasions, nor to undergo duplicative verifications.

The **objective of this initiative is to envision a solution** where a balanced approach is possible in significantly reducing bureaucracy, while increasing transparency and traceability, as well as to facilitate firms' access to wider markets. The vision is **aimed at all firms, but may particularly benefit SMEs** who face a proportionately higher cumulative regulatory and administrative burden relative to their resources. Our recommendation thus strengthens the case for agile SME-focussed policymaking in new economic areas such as digital economy, green economy and circular economy. As SMEs are the largest job creators and backbone of our economy, their sustainable strength is key to economic revival and to ensuring that it is inclusive.

We encourage the G20 Leaders to support the concrete recommendations set out in this paper as part of their priorities, in order to **improve access to trade finance** for all firms as a powerful enabler to support a sustainable and inclusive economic recovery at global level. The COVID-19 pandemic has posed challenges that **require G20 leaders to lend their support to breakthrough efficiency proposals** and policies that fast-track growth, job creation and inclusion, by preserving international partnerships, by building trust and helping to legitimize companies in accessing external markets, resulting in more stable income and faster recovery for the economy. The proposals in this paper can also be piloted domestically, progressing towards a broad acceptance worldwide.



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EXECUTIVE SUMMARY

Context

Having trade operating efficiently and effectively offers lifeblood to the economy. In order to recover from the challenges posed by the pandemic, it is critical to target solutions that foster trade and boost growth through supporting the efficiency and productivity of the private sector activities: **flywheel effects**[1] **that can spark a sustainable economic recovery**, rather than further increase firms' leverage, or subsidies or other support measures that most governments can hardly afford further and may lead to competitive distortions.

Trade finance and financing throughout the **Global Value Chains (GVCs)** are essential enablers of international trade. Trade finance can help enable domestic commercial activity and provide working capital to local businesses, thus ultimately supporting greater resilience of the international trading system.

While public fiscal support and stimulus programs have been essential in addressing the immediate fallout of the crisis, they have had significant implications for public finances. It is therefore critical to maximize firms' cash flows by **improving efficiency and productivity** and minimizing the need for further leverage.

We thus propose to look more closely into **how removing obstacles and cumulative burdens to firms accessing trade finance can spark international trade and business activity, which in turn can positively affect economic growth**, with a particular view on the medium to long-term resilience of the trade financing system. The proposed solutions apply to all firms, but may particularly benefit Small and Medium-Sized Enterprises (SMEs) who face a proportionately higher cumulative regulatory and administrative burden relative to their resources.

This paper builds on and provides a concrete application of the "**GVC Passport**" concept introduced during the 2020 G20 process, which focused on the reduction of barriers that firms encounter in their quest to participate in GVCs. The concept provided a "thought starter" of how to design an authenticated, authoritative, verifiable financial fingerprint of a given entity, enabling it to operate within GVCs without the need to reproduce the same documentation on multiple occasions, nor to undergo duplicative verifications across borders.

Recommendations to the G20

Cutting across the B20 Taskforces and hence in close interlock with their relevant recommendations and policy actions (in particular from the Trade & Investment and the Finance & Infrastructure Taskforces), this paper advances the abovementioned "GVC Passport" work by recommending to the G20 **three concrete actions.** The objective is to foster access to Trade Finance to enable firms of all sizes to participate in and take full advantage of GVCs, minimizing the burdensome and too often duplicative trade finance processes. The recommendation is based on three pillars, which **combined can offer a simple**, though powerful, **enabling framework**:

1. Explore the opportunity to promote the **Legal Entity Identifier (LEI)** as a worldwide unique identifier standard. Being open and non-proprietary, the LEI could facilitate more effective counterparty identification and verification on a global scale.
2. **Legally recognizing digital documentation**, which would allow for a greater use of digital documents in Trade Finance processes, thereby helping to reduce friction and monetary and environmental costs.
3. **Leverage digital technologies** (for example DLTs/blockchains) to support Trade Finance by establishing well-defined security (and cybersecurity) principles and minimum requirements for digital platforms to be trusted ecosystems to be used across GVCs. It is paramount that these requirements are implemented consistently across borders.

While these actions deliver positive impacts on their own, it is their **combination** that could make a substantial difference in the Trade Finance process. **Benefits** of these proposed actions accrue to all stakeholders - private and

[1] The “flywheel effect” is frequently used as a metaphor to help visualize momentum: positive feedback loops that build momentum, increasing the payoff of gradual effort [Collins, 2001]. No matter how dramatic the end result, growth transformations never happen in one fell swoop, but need to build up a continuous momentum.

public - and go beyond overcoming bureaucratic obstacles and burdens in operating through GVCs, leveraging both the existing data from traditional sources and new data arising from digital platforms:

1. **Raise efficiencies** across Trade Finance processes and help simplify burdensome requirements such as in KYC and AML. Firms will not need to duplicate burdensome compliance checks, but can instead draw on already verified documentation, which reduces time and costs.
2. **Facilitate the netting of payments across firms**, hence improving timeliness of payments.[2] This would bring actual cash into firms, supporting their needs without having to build up further leverage or having to resort to public support. Additionally, it will reduce arbitrage at the periphery of trade finance by firms encountering financial difficulties and masking their mounting borrowings.
3. Systematically gathering consistent data can support public administration, making compliance simpler, more consistent, and less costly, as well as **increasing transparency** and especially **"traceability"** of transactions. This can help tackle global challenges such as money laundering and financial crimes.
4. By enabling such a framework, whose components already exist separately, **Governments** can make a tangible difference towards supporting a sustainable and inclusive **long-term economic recovery**, focusing on efficiency improvements, rather than having to commit additional funding resources.

Multilateral Development Banks (MDBs) can also play an important role as market participants by aligning relevant transactions to the above recommendations, helping to render these as standard market practices.

Finally, for the three above recommendations to be fully effective, there is a strong need for **capacity building** to boost the digitalization of processes across firms, with SMEs in particular potentially lacking the financial resources and digital skills to maximize the advantages of the more efficient processes proposed in this paper.

The paper is structured as follows: Chapter 1 establishes that improving access to Trade Finance can be a potent tool in boosting trade and thus ultimately a sustainable economic recovery. The chapter also outlines key obstacles for firms in accessing Trade Finance. Chapter 2 proposes three main recommendations and elaborates on how these can improve the Trade Finance process.

[2] There is one caveat in cases where netting of payments is not possible for tax reasons.

CHAPTER 1 – SUPPORTING RECOVERY BY IMPROVING ACCESS TO TRADE FINANCE

The economic fallout of the pandemic requires decisive policy action

The COVID-19 pandemic has severely negatively affected the world's economies and disrupted cross-border trade and investments. The World Trade Organization (WTO) estimates a decline in volume of world trade due to the crisis of 5.3% in 2020 [WTO, 2021b], posing a severe drag on economic growth. Global foreign direct investment also collapsed in 2020, falling by 42% from USD 1.5 trillion in 2019 to an estimated USD 859 billion in 2020, according to UNCTAD's Investment Trends Monitor [UNCTAD, 2021]. A key policy challenge for post-pandemic recovery is the prevention of widespread insolvencies, while avoiding excessive leverage for both businesses and governments alike. This can be achieved by **offering firms reliable instruments capable of enhancing their efficiency and productivity**, critical to bolster their recovery.

The COVID-19 pandemic has further highlighted the world's considerable interconnectedness and dependence on **Global Value Chains (GVCs)**. Disruption in GVCs does not only have an immediate negative economic impact, but also creates severe long-term damage to the economic fabric of our societies, with many firms facing shrinkages of their own markets.

A key immediate and medium-term **risk from the crisis relates to corporate insolvency, with dramatic spill-over effects on employment.** According to the ILO, in 2020, 8.8% of global working hours were lost relative to the fourth quarter of 2019, equivalent to 255 million full-time jobs. The employment impact of the crisis is particularly severe in countries that lack or have insufficient social protection systems in place. In addition, there is a risk that a sizable portion of firms will start the recovery period with deleveraging pressures and heavy debt-servicing costs, which in turn **may impede them from making productive investments** in the future and from generating jobs. The latent negative implications of debt overhang from non-financial firms have been prominently highlighted by both the OECD and the Group of 30 [G30 2020].

Governments have implemented vast programs of public fiscal support and stimulus in response to the crisis. While essential, these programs, along with automatic stabilizers and lower output levels, have had **significant implications for public finances**, with government budget deficits and debt levels set to see sizable increases in many countries. The OECD estimates that fiscal balances are deteriorating in the median OECD economy around three times as much as during the 2008-09 financial crisis [OECD 2020b].

In such a delicate economic environment, it is crucial to **preserve international partnerships** by building trust and supporting companies' cross-border operations. Free **trade, based on multilateral law,** has been a crucial driver for economic growth, employment creation and development and played a key role in poverty reduction in many economies around the world. It is now more important than ever before to ensure an open, dynamic, multilateral trade system to overcome the devastating employment and economic effect of the pandemic. Finally, it is not only important that the economy recovers worldwide, but in order for growth to be **sustainable** it is **paramount that it is inclusive**, reaching both smaller and larger firms across various markets and regions, and supporting informal firms to emerge.

Trade Finance: a mechanism to jump-start the economic recovery by fostering international trade

Against this background, the way forward must be to **promote concrete policies and measures that could ultimately pave the road to support firms "*going back to work*": flywheel effects that can spark economies again**, rather than subsidies that most governments can hardly afford any further and are short-lived in tenure. It is our view that improving **firms' access to Trade Finance** is a perfect case in point of concrete policy intervention to aid the economic recovery through fostering international trade.

As highlighted by the OECD, "*international trade is associated with positive impact on enterprise growth, spill over-effects for SMEs including in respect to managerial skills, technology and innovation, as well as economic growth*

in general" [OECD 2021]. **No structural and sustainable post-pandemic recovery can be envisaged without fostering trade at its centre**.

Trade Finance and financing throughout the GVCs are, in turn, **essential enablers of international trade**. By ensuring **secure and timely payments** across borders, efficient trade finance significantly supports the optimization of working capital on the buyer side and generates additional operating cash flow on the supplier side. It also offers highly effective risk mitigation, enabling trade in these challenging conditions and markets to which firms have been required to adapt.

Moreover, access to trade finance can **enable SMEs**, which continue to face significant financing gaps deepened by the COVID-19 crisis, to participate in GVCs. This allows SMEs to access new markets and better engage in international activities, which is vital considering the role SMEs play for economies and societies by creating employment, contributing to economic growth and GDP and addressing societal needs. Additionally, with a decrease in trade risk comes a significant reduction in insurance costs, which provides additional capital that can be devoted to trade and other productive activities, thus creating a "virtuous" circle, particularly beneficial to smaller firms.

Obstacles in accessing Trade Finance have been aggravated by the COVID-19 pandemic

It is concerning that trade finance is still hampered by a number of obstacles, limiting growth opportunities offered by GVCs, as outlined in a recent *Business at OECD* contribution to the B20 [*Business at OECD,* 2020].

Since the start of the health crisis, trade finance has experienced an increase in the financing gap between demand and supply, with demand outpacing supply by an estimated USD 3.4-6.5 trillion, to be able to meet the SDGs [SC, 2020]. Yet, challenges already existed before the crisis. The typical cost-to-income ratio in traditional trade finance is 50-60%, meaning that more than half of the price charged to clients for trade is used to cover operational expenses, even before covering the costs of risk, liquidity and capital. From an operating cost perspective (e.g. document wait times), Bain & Co. estimates that enhancing process efficiency could reduce such costs by 50-70% and turnaround times could be improved three to four fold, depending on the trade finance product involved [Bain&Co, 2018b].

Smaller firms have particular difficulties in accessing trade financing. For example, in Africa trade finance rejection rates for SMEs have doubled between 2015 and 2019. The WTO's Informal Working Group on MSMEs [WTO, 2020] noted that the major obstacles to MSME participation in international trade include difficulties in accessing finance and the challenges associated with cross-border payments: today's trillions of dollars in **late payments are a major constraint on SME participation in cross-border trade**.

Notably, access to trade finance results from three obstacles, each aggravated by the pandemic:

1. **Cumulative regulatory and administrative burdens:**
    - On-boarding requirements around anti-money laundering (AML) and know-your-customer (KYC) regulation are of upmost importance, but also **resource-intensive for firms**, constituting a large barrier for banks to make their trade finance products available at a competitive cost to a wide range of players, particularly the smaller ones [Kim et al. 2019]. From 2015 to 2019, 16% of banks surveyed listed KYC compliance as the third most significant reason for rejecting trade finance applications [AFDB, 2020], citing missing information or knowledge of the process as common reasons for rejection.
    - Trade finance has been negatively affected as a result of a **rise in the cost of capital** under the key ratios segment of the Basel III measures, leading banks to shrink their balance sheets. The trade finance industry (through the ICC - International Chamber of Commerce) has made specific recommendations on how to better recognize the trade finance characteristics in the Basel framework, which should be further considered by the Basel Committee in light of the pandemic's impact on trade.

One resulting **unintended consequence** of these regulatory measures relates to a crowding out of trade finance products in support of invoice financing and other similar forms of financing such as bank-to-bank or subsidiary-to-subsidiary finance that support the working capital of individual entities, e.g. **masked lending**, with potentially negative implications. Additionally, trade financing shifts towards **shadow banks**, which benefit in terms of cost by not having to adhere to those very regulations applied to regulated banks. This poses concern to the financial stability of the economic system as these entities lack the inbuilt safeguards of the standard regulatory framework.

2. **Paper-based documentation is inefficient** and the pandemic disrupted processes even further:
   - The trade arena and the rules that govern it are still geared towards paper-based manual processing, posing a particularly salient obstacle during a global health crisis such as a pandemic.
   - Inefficient documentation processes including manual contracts, multiple checks or duplicate bills lead to complexities and delays, frequently with the physical goods moving more efficiently than the paperwork.

3. **Lack of end-to-end (or inter-operable), easy to access, transparent platforms**:
   - Multiple platforms used by numerous players lead to a fragmented landscape and pose challenges for initiatives to operate at scale [OECD, 2021] and may increase risk of miscommunication and fraud.
   - A single trade finance transaction generates on average hundreds of data field interactions, again increasing the risk of miscommunication and fraud. The variety of documents and data fields involved in the process creates a chain of discrepancies, with only 1-2% of the data entered estimated to generate real added value [BCG, 2019].
   - Trade finance may not be sufficiently visible nor understood by users, especially by SMEs, which are generally disadvantaged due to skills gaps in communicating their financing needs. High costs of adaptation play a role, too, including funds for investment in digital skills attraction or development [OECD, 2021].

As a result of the pandemic, the risk of loan defaults by different parties across the GVC is inevitably increased and lenders are now more cautious about new lending.

It is therefore critical to maximise firms' cash flows by improving the efficiency of the trade financing process, minimizing the need for further leverage and avoiding further fuelling the abovementioned unintended consequences. This could aid companies in accessing new markets, resulting in additional business opportunities, with a much-needed positive impact on employment across the value-chain, including in different markets and regions. **In a nutshell, properly improving access to trade finance can deliver a robust economic recovery that is evenly distributed across firms of all sizes, markets and regions, thus being sustainable and inclusive**.

CHAPTER 2 – CONCRETE STEPS TOWARDS EFFICIENT AND EFFECTIVE ACCESS TO TRADE FINANCE

Innovation must be at the heart of regulatory policy-making as it drives improvements in productivity and sustainable economic growth. To foster innovation, governments can improve the regulatory environment by adapting existing rules to new technologies to ensure that they are fair, predictable, consistent, easy to enforce and administratively efficient throughout the process. Compliance can be made more consistent, less costly and less complex, thus improving its **transparency and traceability**.

This paper aims to outline how having a holistic view of trade finance processes and removing specific obstacles and cumulative burdens to firms accessing them can boost trade financing, which in turn can positively induce economic sustainable and inclusive growth, with a particular focus on the medium to long-term resilience of the trade financing system.

If jurisdictions recognize a more systematic and globally consistent use of digital technologies in their legislations and regulations, leveraging both the existing data from traditional sources and new data from digital platforms, this will help to overcome some of the high administrative, compliance (e.g. AML and KYC requirements) and transaction costs. A more systematic and consistent use of digital technologies will, in turn, enable trade financing to be more easily accessible to both SMEs and larger corporates on a long-term basis.

Policy-making thus has a key role to play in setting the right conditions for trade and investment in general and in supporting firms' integration in GVCs in particular.

It is, however, not just a question of public policy and regulation. Commercial decisions also affect the evolution of the global trading landscape. For instance, an ever increasing number of businesses opt to simplify transaction processing with stakeholder and government bodies (e.g. Open Account trade), and many banks have been incentivizing corporates to adopt digital solutions, though both still remain scarce at this point.

There are a number of options, leveraging on best practices, to reduce financial regulatory obstacles to GVC integration and to strengthen trade finance. For example, this paper leverages on the work started in 2020 by the B20 and *Business at OECD* under the Saudi Arabian Presidency proposing the "**GVC Passport**" concept [B20-*Business at OECD*, 2020], which could provide an authenticated, authoritative, verifiable financial fingerprint of a given entity, enabling it to operate within GVCs without the need to reproduce the same documentation on multiple occasions, nor to undergo duplicative verifications.

The "GVC Passport" would allow a firm to be recognized as a legitimate business partner, compliant with the credit and financial regulations relevant to the GVC it operates in. The concept is envisioned as **a set of Finance related verifiable credentials to be cryptographically encrypted and verified** (i.e. done by a permissioned entity in an accountable and immutable way that can be transparent and traceable) between peers at the opposite ends of the GVC network. This would not avoid the firm having to comply with the rules, but it would ensure that it has to prove **only once** that it meets them through a single authentication that **can be verified** throughout the GVC. Critical is the fact that the Passport would not be a new document to fulfil, but it would rather **compile and recognize certifications already received**, to avoid the need to fulfil them again in the next country or transaction. Such certifications would be kept up-to-date with the latest validation or relevant regulation, and could be verified real-time by the authorized parties, hence avoiding firms having to reapply, update or run through additional bureaucratic steps.

The "GVC Passport" was a concept intended as an aspirational long-term vision to enable firms to participate in and take full advantage of GVCs, minimizing burdensome and too often duplicative processes. **This paper takes a concrete step forward** by proposing some actions, which, if consistently adopted throughout a GVC, can bring significant benefits in terms of more efficient access to Trade Finance, strengthened compliance, increased traceability, and easier **netting of payments across the GVC**. These actions will thereby also benefit firms' cash flows, reducing the need for leverage and thus supporting activity over the longer-term in the post-pandemic environment. The action items outlined in this paper are aimed at all firms, but may particularly benefit SMEs who face proportionately higher cumulative regulatory and administrative burdens relative to their resources.

Notably, we propose actions across three core steps of the trade financing process:

a) **Know your counterparty** by making wide use of the Legal Entity Identifier (LEI);
b) Materially improve documentation flow by making **digital documentation** accepted by legislations;
c) Offer a **trusted and reliable platform** leveraging on technology with clear safety and data protection requirements to facilitate Trade Finance.

a) Leveraging on the Legal Entity Identifier (LEI) for reliable counterparty identification

To operate effectively throughout the GVC and to more easily comply with AML and KYC processes, **reliable counterparty identification** is critical. This has been recognized by members of the Group on SMEs, which called on WTO members [WTO, 2020] to address such challenges through capacity building and information sharing.

Similarly, at the G20 level the need for reliable counterparty identification has been recognized. Following the 2008 global financial crisis, the G20 called on the Financial Stability Board (FSB) to provide recommendations for a **Global Legal Entity Identifier (LEI)** and a supporting governance structure. The LEI was then embraced by the regulators in G20 jurisdictions as a solution to identify counterparties in over-the-counter derivatives markets.

The **LEI is a worldwide unique identifier** based on the ISO standard 17442. The LEI is intended for identifying parties in any financial transaction and has well exceeded its original applications in derivatives and securities markets. The LEI equips legal entities with a global, digital identity and enhances interoperability in digital finance applications and payments.[3]

As such, the LEI is part of the Financial Stability Board's proposed enhancements to make cross-border payments more transparent, efficient and inclusive for all users (ensuring to avoid any unintended discrimination). Being an open and non-proprietary standard, it can facilitate more effective counterparty identification and verification on a global scale by providing a universally recognized identifier paired with essential entity data, rigorous verification processes and **high data quality, which helps increase transparency and traceability**.

Both the Asian Development Bank and the African Development Bank confirmed the usefulness of the LEI for creating a standardised, reliable, global identity to:

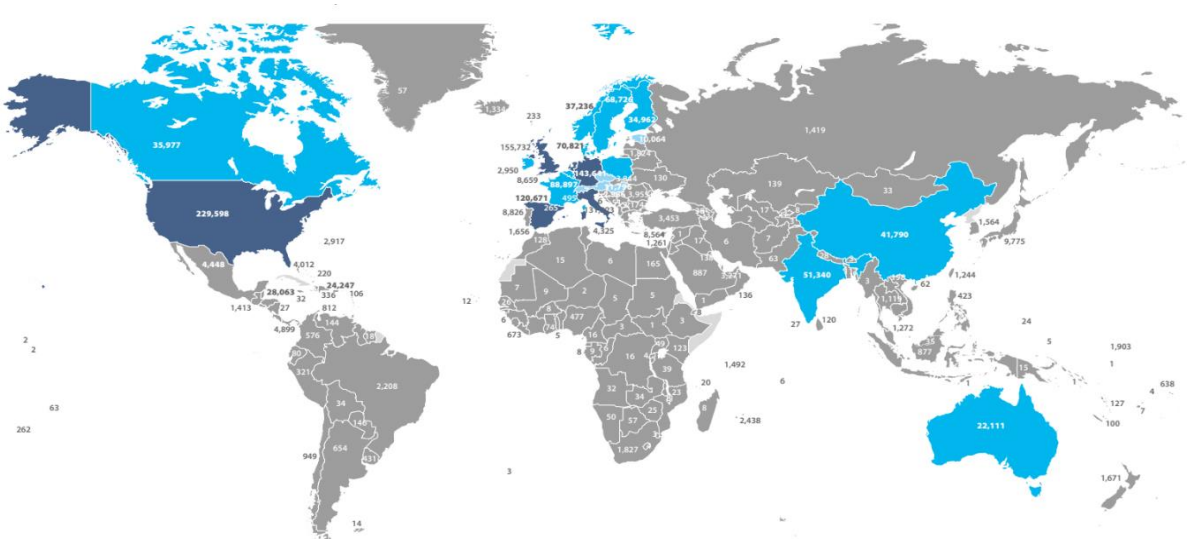
i) Mitigate the risk for the correspondent bank - customer relationships being de-risked;
ii) Increase SMEs' access to finance in emerging markets by easing the flow of reliable information; and
iii) Promote development of financial technologies, blockchains and similar platforms to reduce costs.

Importantly, the LEI, a global open data standard, **does not contain confidential** (private) **information**; therefore, it does not pose confidentiality threats in respect of information exchange. On the contrary, by providing a unique identifier, the LEI can help create an open and transparent ecosystem (e.g. for KYC purposes), where relevant financial institutions benefit from swift identification of new clients, while reducing duplicative work involved in having to gather themselves the information already captured by the LEI.

Currently, there are over **200 jurisdictions where at least one LEI is registered** as depicted in Figure 1. GLEIF[4] - the organization that manages LEI - continues to work with the FSB to further encourage the adoption of LEI in identifying beneficiary and originator in cross-border payment messages[5]. In the EU, the European Systemic Risk Board has called on the European Commission [ESRB, 2020] to create an EU legal framework for broader adoption of the LEI also for non-financial corporations and to consider the LEI in any new or amended legislation.

[3] Some examples include identification of large corporate borrowers in India, parties in payment messages in India and UK, import/export firms for customs in China and the United States, and funds in asset management and insurance in the EU.
[4] Established by the FSB in 2014, the **Global Legal Entity Identifier Foundation (GLEIF)** is tasked to support the implementation and use of the LEI. The foundation is backed and overseen by the LEI Regulatory Oversight Committee, representing public authorities globally that have come together to jointly drive forward transparency within the global financial markets. GLEIF is a supra-national not-for-profit organization headquartered in Basel, Switzerland.
[5] The Bank for International Settlements Committee on Payments and Market Infrastructure (CPMI) suggested the LEI as a unique identifier for precisely identifying the beneficiary and originator in payment messages in their Stage 2 report to the G20 [BIS, 2020]. As part of the implementation of the concluding Stage FSB report [FSB, 2020b], LEI features prominently as the solution as a digital unique identifier for identifying legal entities in payment transactions.

Figure 1: Total Number of Active LEIs by Jurisdictions



Source: GLEIF, 2021

This paper **recommends that the G20 makes the LEI the global identification standard for financial transactions across GVCs and removes its related costs to firms.** Currently, entities pay for obtaining and maintaining a LEI, with annual costs ranging from 50 USD to 220 USD depending on the costs in a given jurisdiction. The Global LEI System is based on the cost recovery principle, which means that LEI Issuing Organizations (LOUs) are not allowed to profit from the LEI business. There are cases where the LOU does not charge any fee for the LEI registration, as for example the China Financial Computerization Corporation, an LOU based in China.

The arising costs for promoting a more global use of the LEI could, but do not necessarily need to be fully financed by the public. For example, under the Validation Agent framework,[6] GLEIF pilots the applicability of financial institutions issuing a LEI for each on-boarded client by partnering with accredited LOUs in order to reduce costs for legal entities obtaining a LEI [GLEIF, 2020].

A more global use of the LEI can greatly aid KYC and AML processes. At present, the KYC data landscape is fragmented globally. Different financial institutions hold information on the same customer, which overlap and may frequently be inconsistent and incomplete. This leads to inefficiencies, excessive procedural costs for firms and weaknesses that criminals can exploit. Therefore, **if LEIs were used by all financial institutions at the time of on-boarding to tag legal entity clients,** this could significantly minimize the burden of KYC, AML and other processes requiring validation of identity for both firms and financial institutions, **by:**

1. Avoiding clients having to undergo duplicative procedures for transactions with other financial institutions. Firms would in fact have to apply only once as the financial institution can validate the LEI, and financial institutions would not need to repeat the whole procedure every time.
2. Ensuring maximum transparency, interoperability and clear communication with investors and supervisory authorities.
3. Allowing for information exchange between financial institutions. For example, if an entity is identified as associated with a politically exposed person, the entity providing the verification for the customer could flag the associated LEI, and the information would flow seamlessly to other financial institutions.
4. Helping to prevent fraud with regards to financial transactions and misidentification.

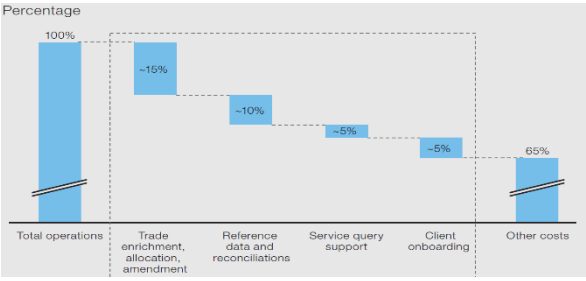
Making the LEI the global identification and entity verification standard for financial transactions across GVCs would both **ease its processes and bring transparency and traceability** across Trade Finance processes.

[6] For more information on GLEIF validation agents: https://www.gleif.org/en/lei-solutions/validation-agents

Finally, from the banks' cost perspective, **identity verification** is frequently based on name matching and cross-checks, and thus it is prone to incorrect identification and is resource intensive for both financial institutions and firms, particularly SMEs.

Notably, the use of the LEI in the on-boarding and trading phases of the client relationship would reduce the time spent on data correction and reconciliation. About 35% of total trade processing costs can be streamlined through the use of LEIs, with a potential to optimize 10% of these costs.

Figure 2: Annual operations costs - global banks



Source: McKinsey & Company, 2017

b) Legally recognizing digital documents to improve trade documentation processes

In today's open and global economies, trade faces a surprising contradiction: supply chain processes rely on sophisticated logistic and information processing technology, while the core documentation exchange that steers and controls the acquisition, transport and payment processes is still relying on paper-based documents. High costs of adaptation play a role, too, including funds for investment in digital skills attraction or development [OECD, 2021]. This leads to inefficiencies and high costs in GVCs, estimated at 5% to 10% of traded goods' value.

The challenges relating to the acceptance of digital documentation posed by current legislations worldwide become evident when moving from general enabling concepts to more concrete legal implications. Domestic legal frameworks underlying trade activities in most countries do not recognize or require some legally-enabling constraints to affirm the legal validity of electronic documents, electronic signatures and other data-regulation requirements. A survey of 128 countries conducted by the UN [UN, 2019a] on measures related to trade facilitation and paperless trading showed that automation of trade procedures and use of electronic data and documents are **still lagging in implementation in many countries**. Only about 36% of countries have implemented measures related to the cross-border exchange of electronic data and documents, substantially lower than that of other groups of measures.[7] Only a handful of countries (e.g. Singapore) fully recognize digital trade documentation in their legislation.

The challenge in an international trade context resides in the fact that it is ineffective if customs and regulatory agencies accept digital data, but then also require the original paper documentation. As outlined in the UNECE White Paper on Paperless Trade [UNECE, 2017], "***a paperless system that still requires the submission of paper-based documents at some point in the trading chain destroys much of the value of the digital tools for traders***".

This is particularly important in a cross-border environment where a transaction initiated in one country, in which that digital documentation has been legally enabled, may not be legally recognized in an importing country, or vice-versa.[8] For example, some customs authorities (or other government agencies) may reject electronic documents from those countries that do not have equivalent enabling laws that authorize the use of electronic documents. Similarly, trading partners may be hesitant about dealing with electronic filings in countries that do not have enabling laws because of the legal uncertainty about such transactions.

Typically, an enabling framework consists of a body of legislation, which caters to the various needs of the paperless trade environment in general and thus provides for general rules on, e.g., data privacy and the use of electronic signatures. **Those provisions of general application should be based on best practices and**

[7] It must also be noted that some countries only accept very burdensome types of advanced electronic signatures such AES or QES signing, which require the end-user to go through lengthy processes to create a qualified signature. Albeit these types of signatures are secure, they may discourage smaller players, who need easier and faster solutions.

[8] This can be particularly challenging in some civil law jurisdictions such as Spain and Italy, which still require the notarization of particular documents for them to be considered validly executed.

internationally accepted standards and principles, taking into consideration national and sectoral conditions and circumstances.

The COVID-19 crisis by limiting physical interactions, has helped to progress on digital transaction recognition, particularly by making evident the need to push efforts toward digitalizing trade transactions, which can improve today's paper-based documentation processes, providing strong gains in efficiency. For example, digitalizing paper documents reduces friction and costs such as printing, handling and transportation of typically hundreds of pages amongst numerous parties, thereby significantly reducing the costs of shipping tradable goods.

Firms, and especially SMEs, had to enhance their digitalization to operate throughout the pandemic; governments, on their end, need to make the regulatory environment adequate for firms to build their business. It is therefore very **important to review and enhance existing laws to accommodate for digital documentation** ensuring that both lessons and advances instigated by the pandemic are not lost.

National laws worldwide should make it clear that electronic documents and data should be recognized in judicial or administrative proceedings related to trade transactions. Reform can be undertaken in a number of ways, from adopting new legislation or through government decrees. Alternatively, it may be possible to amend the existing customs' law to include digital trade documentation as valid records. This does not mean that all electronic documents must be accepted as evidence in any proceeding, but only that they should not be rejected solely because of their electronic rather than paper-based nature.

Additionally, for **cross-border trade to be fully paperless, trading jurisdictions need to mutually recognize such documents as valid titles: they need to provide legal certainty** to electronic transactions and legally recognize electronic negotiable instruments. A working example is offered by electronic Bills of Lading (eBLs) in Singapore.

The **current technology already allows title transfers on trade documents electronically**, which is pivotal in transforming paper-based processes to digital ones for cross-border trade. With digitized documents, for example, as detailed later in *section 2c*, the use of Distributed Ledger Technology (DLT) could improve the efficiency and accuracy of the workflow by making the entire transaction history and its collateral information more transparent. If all the relevant documents are digitalized, smart contracts can enable exchanges, payments and other transactions to occur automatically. **It is clear that technology alone is not enough**: **harmonized legislative reform and common standards** (from an invoice, to a financing product, to identity and security) are **vital enablers** of trade digitization.

The UN Commission on International Trade Law (UNCITRAL) has put forward an international attempt to provide a legal framework for electronic trade documentation, which can be adapted and adopted by individual jurisdictions: the Model Law on Electronic Transferable Records (**MLETR**)[9]. MLETR allows legal use of transferable documents and instruments in electronic form both domestically and across borders. It establishes that electronic trade documents gain the same legal standing as those paper-based, if that record contains the information required in the paper-based equivalent and if they are functionally equivalent as a reliable method used to:

a) identify that electronic record as the electronic transferable record;
b) render that electronic record capable of being subject to control from its creation until it ceases to have any effect or validity; and
c) retain the integrity of that electronic record.

Controls are fundamental to the MLETR, which also provides guidance on assessing the reliability of the method used to manage an electronic transferable record. In 2021 Singapore has become the second country, after Bahrein, to adopt the MLETR into domestic legislation. In April 2021, the UK also set out provisional proposals for law reform [UK, 2021] to allow for electronic trade documents to have the same legal standing as their paper equivalents, provided that they meet certain requirements to enable their possession in a digital context.

Finally, and not to be underestimated, there is a strong need for **capacity and infrastructure building** to boost paperless trade use across firms. SMEs and e-traders may lack access to the platforms or have to pay high usage

[9] UNCITRAL Model Law on Electronic Transferable Records - Date of adoption: 13 July 2017.

rates. Even with access, they may not have **the digital skills** to use new IT systems or services, or be able to maximize the advantage of going paperless. Indeed, a joint IOE-ILO-KAS research [IOE, 2021] shows that after considering external factors, the major impediments for SMEs to tap into the possibilities of digitalization are the lack of digital infrastructure and insufficient digital capabilities.

c) GVC ecosystems to be built on data verification and safe digital platforms

E-commerce platforms support millions of firms delivering goods and services to international markets with unprecedented ease, which has become ever more evident during the pandemic. Similarly, **online platforms are increasingly connecting finance providers with buyers and sellers in order to provide traditional trade finance solutions** [GSCFF, 2016; Van Wersch, 2019; ICC, 2018]. In particular, smaller enterprises have never before been able to access infrastructure and global logistics networks with so little capital expenditure, making them able to continue to operate during lockdowns. Many of those platforms are developed and backed by financial institutions, often times in collaboration with technology companies.

Distributed Ledger Technology (DLT), including for example blockchain, **can facilitate trade by speeding up trade financing and customs procedures** and thereby taking forward the Bali Fintech agenda.[10] Notably, the required technology does not need to simply encompass wide storage systems, but rather help organizing data and eliminating data silos, with the objective of creating trusted sources of standardized information: **platforms** containing much richer datasets than those existing in any one system today to be used by all GVC participants. The reconciliation of data through common digital platforms, such as blockchains, can each, independently, contribute to increased efficiencies in record keeping both within organizations and across firms and GVCs. But, if they were to work together in a standards-based framework, the sum would be much greater than its parts.

Structured with the required access permissions, digital platforms can also be used as infrastructure for **identity attestations,** providing participants with proof of authenticity and origin for the required documents. As such, a permissioned ledger can **improve operational efficiency** enabling a safer, cheaper and more seamless flow of goods between digitally interconnected trading partners, compared to loosely connected participants of traditional processes. Finally, more reliable data contributes to improved quality of credit risk assessments [ICC, 2019], further benefiting the firms' access to finance. A concrete example is offered by TradeTrust in Singapore[11]. It is also worth noting the “Contour” initiative, which gathers approximately fifteen international banks active in trade finance to facilitate letters of credit by exploiting blockchain.

DLT/blockchains, which are properly structured to satisfy the regulatory and compliance requirements, can provide a transparent, traceable, immutable, reliable and auditable infrastructure to seamlessly and securely exchange cryptographic keys. It is therefore **paramount that adequate requirements and encryption mechanisms are set up** to ensure that platforms built on such technologies can be properly trusted and that cybercrime is prevented.

To ensure data protection and safeguard business confidentiality, **it is important to design platforms where underlying data itself does not need to be shared, but where certain mechanisms allow for data to be nonetheless verified to ensure that the information reported is correct.** This could be done by cryptographically sharing verifiable credentials throughout the GVC network, which allows for identification and data verification without sharing the relevant underlying data. For instance, a qualified **digital certificate** guarantees the identity of the signer and its e-signature guarantees document integrity and frames it in time by using a qualified time stamp, complying with **data privacy agreements** already signed across the G20. Incorporating a LEI, as introduced in section 2(a) into digital certificates and document e-signature processes could provide an additional layer of

[10] International Monetary Fund (IMF) and World Bank launched the Bali Fintech Agenda in 2018 [IMF, 2018]: 12 policy factors aimed at supporting countries to harness benefits and opportunities in financial technology, while managing the risks.

[11] One of the first platforms built on the TradeTrust framework was co-developed by ICC together with tech firm Perlin, in collaboration with IMDA, commodities trader Trafigura, and DBS Bank. A USD20M pilot trade was executed in November 2019, with an iron shipment from South Africa to China. Documentation time was cited to be reduced from 45 to 20 days.

verifiable proof, since the LEI is a global secure mechanism that provides reliable data on organizational identity.[12] Such a framework offers an efficiency opportunity to **maximise the use of existing data** and to ensure transparency and traceability, while protecting participant data and avoiding the unauthorized sharing of underlying data and confidential information.

In **Trade Finance, the ultimate objective of the process is to confirm a firm's compliance with relevant rules and regulations, not to obtain the full data history.** Thanks to advances in DLT/blockchain, both digital identity management and decentralized identity verification are now possible and can be combined into systemic solutions serving a wide population. The recipient of a **verifiable credential** in a peer-to-peer connection would use the associated globally unique identifiers as a resource locator for the sender's public verification key, so that the data in the verifiable credentials can be decoded and validated [IBM, 2018]. Moreover, digital tools allow combining and crosschecking of data across a large variety of databases, enabling real time verification.

Data itself needs to be up-to-date, possibly in real time[13] and should offer a degree of granularity, which allows it to meet the widest possible set of requirements. Ultimately, there needs to be a mechanism that guarantees that the verifiable credentials are in fact backed by **reliable and trustworthy** data. Successful implementation of DLT/blockchain-based trade facilitation critically depends on sound legal and regulatory provisions within legal frameworks. The UN outlines a conceptual model for trade technologies [UNECE, 2019] that may facilitate and clarify the process by providing clauses or provisions to be incorporated in acts and regulations to be suitably updated or aligned in each jurisdiction. Such provisions should include, but are not limited to, the following:

- Recognition of records in DLT platforms, with the required permission, in courts of law;
- Cross-border (cross-jurisdiction) boundary and dispute resolution;
- Data capture, storage, ownership, sharing and security provisions;
- Minimum standards for certification, compliance, transparency, and accountability;
- Facilitate interoperability; and
- Registration of blockchains that satisfy the established set regulatory and compliance requirements.

The OECD is also seeking to provide a clear and coherent policy framework: it is currently working on developing high level guidance on responsible blockchain innovation and adoption, for use by all stakeholders. We welcome the development of such guidance, which identifies similar elements aiming at preventing and mitigating risks, while preserving incentives to innovate, collaborate and compete.

In summary, developing **"GVC ecosystems" built on trustworthy and safe principles and requirements will benefit all players**, including paving the road to enhanced SME participation in GVCs. Moreover, reliable certification can contribute to financial crime prevention, such as money laundering or terrorist financing, which are ever growing risks in trade whereby criminals use a legitimate trade to disguise criminal proceeds.[14]

Importantly, it is worth clarifying that such "GVC ecosystems" are agnostic to the nature of the technological solution itself (e.g. blockchain versus other digital solutions). However, it is important is to promote uniform principles and practices at the international level to accelerate the digitalization of trade finance and make exchanges smoother, easier and less costly through digital platforms in order to enhance global trade. Platforms themselves need to be safe, transparent, innovative, easy to access, and recognized on a global scale.

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[12] GLEIF recently announced its issuance and technical infrastructure models for its **verifiable LEI** (vLEI) system. A vLEI is a secure digital attestation of a conventional LEI. When fully developed, the vLEI will enable instant and automated identity verification between counterparties operating across industry sectors, globally.

[13] A real-life example of how DLT have been adapted to trade processes is Rice Exchange which is a private permissioned DLT solution, implemented by Fujitsu, for the trade and commercialization of rice. It is the first fully-integrated platform for the global market enabling buyers, sellers, and service providers to connect in digital form. Trades can be conducted and insured, with agreements on shipping and settlement underpinned by verifiable data.

[14] Trade based money laundering, or the deliberate falsification of the value or volume of an international commercial transaction, is the largest component of illicit financial flows, measuring up to US$1 trillion for developing countries, according to Global Financial Integrity (GFI). It estimates that on average over 80% of such illicit financial flows were due to fraudulent mis-invoicing of trade. See: GFI, GF Trade, *"Trade Misinvoicing Risk Assessment".*

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LIST OF ACRONYMS

AES	Advanced Electronic Signature
AML	Anti-Money Laundering
BAFT	Bankers' Association for Finance and Trade
CCF	Credit Conversion Factor
CFT	Combating the Financing of Terrorism
DLs	Distributed ledgers
DLT	Distributed Ledger Technology
EBIDA	Earnings Before Interest, Depreciation and Amortization
EU	European Union
FSB	Financial Stability Board
GLEIF	Global Legal Entity Identifier Foundation
GDP	Gross Domestic Product
GDPR	General Data Protection Regulation
GVCs	Global Value Chains
ICC	International Chamber of Commerce
IFC	International Finance Corporation
IFSA	International Financial Services Association
ILO	International Labour Organisation
IRB	Internal Ratings-Based
ISO	International Organisation for Standardisation
KYC	Know Your Customer
LEI	Legal Entity Identifier
MDBs	Multilateral Development Banks
MPIA	Multi-Party Implementation Agreement
OECD	Organisation for Economic Co-operation and Development
QES	Qualified Electronic Signature
SDGs	Sustainable Development Goals
SME	Small and Medium-Sized enterprise
UN	United Nations
UNCITRAL	UN Commission on International Trade Law
WCO	World Customs Organization
WEF	World Economic Forum
WTO	World Trade Organization

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