SUMMARY OF SPECIAL STUDY

Trade Facilitation Programme

Regional

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EBRD EVALUATION DEPARTMENT

European Bank
for Reconstruction and Development

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Executive Summary

Background

The Trade Facilitation Programme (TFP) was established in late 1998 and was first evaluated under an Evaluation department (EvD) Special Study in 2003, when it was described as a successful programme. Since then, TFP has developed and evolved considerably. This EvD Special Study (or 'Study') therefore takes a fresh look at TFP, from inception up until October 2009. The Study assesses the performance of TFP under relevance, efficacy, efficiency and impact and in the course of this assesses the extent to which TFP has fulfilled or is continuing to fulfil its objectives; is contributing to the Bank's transition impact mandate; and the extent to which implementation has been generally consistent with the broader policy and procedural context in which the Bank operates, taking into account the special nature of the EBRD as a multilateral development bank.

TFP pursues its objectives through three products: guarantees, cash advances and training/technical consulting. Under the guarantee product, credit enhancement may be required for participating banks whose credit rating is not sufficiently strong on the international market to be accepted by counterparty banks. The EBRD provides credit enhancement in the form of a counter guarantee, issued by the EBRD to cover the credit risks taken by counterparties on the participating banks.

Under the cash advance product, TFP provides credit lines to eligible banks for the purpose of on-lending to customers to fund trade related transactions. Unlike TFP's guarantee products, there is no international/third party bank involved between the local bank and TFP.

TFP mobilises donor support and organises training and technical consulting provided to banks in the countries in which the EBRD operates. Training usually takes the form of basic or advanced trade finance practice. Consulting may include developing or redesigning the trade finance business model of a bank including commercial and risk management policies, upgrading systems, processes and procedures.

Overall rating

The Study provides an **Overall Rating** of TFP of ***Partly Successful***, which is a composite of the individual rating criteria, weighted in line with the Banks Evaluation Policy[1]. The Study concludes that, at inception, Relevance could be rated as *Good* to *Excellent*. However, the departure of instrument design from the evolving market needs points to a Relevance rating of *Marginal*, offset to some extent by resurgent Relevance of the guarantee product in the crisis environment. Giving balance to these two different time periods and the appropriate nature of technical co-operation initiatives, overall **Relevance** is considered to be ***Satisfactory***. **Efficacy** is rated as ***Marginal*** on the basis that two objectives are not considered as achieved (foster trade and provide liquidity). Track

[1] The Bank's Evaluation Policy gives weighting to Transition Impact, Financial Performance and Achievement of Objectives. Respective ratings of Satisfactory, Satisfactory and Marginal correspond under Evaluation Policy to an Overall Rating of Partly Successful.

records and capacity building are considered to have been achieved. With respect to Efficiency, TFP financial performance is broadly in line with expectations (subject to credit losses now being incurred), and the business model has been orientated to the fast turnaround and volume orientated nature of TFP transactions. **Efficiency** is therefore rated as ***Satisfactory***. Transition impact under guarantee activities and capacity building alone is sufficient to merit an ex post rating of *Satisfactory* to *Good*. However, cash advances were the dominant product for three years and are seen to generate marginal transition impact at best. On this basis the **Transition Impact** rating is limited to ***Satisfactory***, underpinned by historic guarantee and capacity building activities.

Relevance

TFP was initially established as a guarantee product focusing on letters of credit, with some other limited guarantees focusing on bonds and other forms of guarantees, as well as cash advances for transactional secured pre-export finance. At the time there was a clear market need for a programme such as TFP to support the establishment and development of bank-to-bank networks and commercial linkages through the provision of risk cover. In these early days, few alternatives existed in the market for risk cover for certain banks in the countries in which the EBRD operates.

In the second phase of TFP's evolution, there was a change in emphasis to cash advances which coincided with a decline (but not cessation) in the relevance of the guarantee product. By this time, networks had been established and the population of issuing banks began to stagnate. This was reflected in a levelling off and eventual decline in guarantee issuance. The cash advance product was extended to financing of downstream trade activities, often one or two-steps removed from the actual trade. The application of the cash advance product to all parts of the transaction cycle weakened the direct linkage to trade and began to look more like funding for working capital.

The subsequent period was characterized by a general increase in the risk appetite of confirming banks to take more risk on TFP banks which was reflected in more clean lines and higher risk sharing, as well as increased cover from private credit insurers and Export Credit Agencies (ECAs), particularly in the key TFP markets such as Russia, Ukraine and Kazakhstan. Even the higher risk markets such as Moldova and Macedonia enjoyed the increasing presence of international banks. This period was also accompanied by declining guarantee business, rising cash advances and a downward trend in pricing.

Prior to the crisis, banks had to a very large extent established international networks. Lack of bank networks and linkages was no longer a major impediment to trade development. Rather, the availability of credit (acceptance of bank risk) was a limiting factor on the financial sector's role in supporting trade development, and even then for some markets it is arguable that access to credit ceased to be an issue for a period. In the crisis period the guarantee product has re-emerged but there has been a shift in emphasis of the TFP guarantee product to post financing letters of credit financing, which is arguably supporting inter-bank rather than trade, finance. Where the international funding bank receives the benefit of an EBRD guarantee, it is able to extend a credit period to the issuing (importer's bank) with zero capital allocation under Bank for International Settlement (BIS) rules. *New process are required under post financing to ensure that the EBRD guarantee is linked to trade, not just to interbank credit.*

Throughout the period, there was a requirement for established trade finance participants to be reskilled and new entrants to be trained. TFP's technical co-operation has been an important feature. The resources and skills that TFP has channelled into both formal and informal (learning by doing) forms of capacity building are almost unique, only replaced in some markets by the arrival of major international banks and commercial partnering between issuing and confirming banks.

The Study concludes that, at inception, **Relevance** could be rated as *Good* to *Excellent*. However, the departure of instrument design from the evolving market needs points to a Relevance rating of *Marginal*, offset to some extent by resurgent Relevance of the guarantee product in the crisis environment. Giving balance to these two different time periods and the generally satisfactory relevance of technical co-operation initiatives, the overall Relevance is considered to be ***Satisfactory***.

Efficacy - TFP's fulfilment of programme objectives

Since 2000, TFP's programme objectives have been described in Board documents as:

1. *foster trade, both intra-regional and inter-regional;*
2. *provide liquidity to the trade finance system;*
3. *assist participating banks in creating track records with international banks; and*
4. *strengthen the participating banks' trade finance capabilities.*

Evaluating the extent to which TFP fulfilled its objectives is particularly challenging as the objectives are so vaguely worded and open to interpretation. In turn, the measurement parameters proposed are input/output based and give little guidance as to the achievement of programme objectives.

1. Fostering trade

The programme objective to foster trade has never been defined clearly and is at best a sweep-all for the other three objectives. With respect to cash advances, where it is not possible to ascertain the linkage to trade, it is hard to argue that TFP has facilitated trade at all, much less fostered it under the cash advance product.

2. Providing liquidity to the trade finance system

The concept of providing liquidity to the system was also never defined in any detail. TFP volume is small relative to the size of trade in the region, so its contribution to providing liquidity is limited in a macro context. At the transaction level, both TFP guarantees and cash advances have an immediate liquidity effect. Whereas this seems obvious for cash advances, it is also very much the case since the issuance of letters of credit or other forms of guarantees allows the issuing bank and its corporate client to preserve liquidity during a period which is pre-defined in the trade and credit agreements. Due to the TFP guarantee, issuing banks would not be required to put up cash collateral thus helping banks preserve liquidity. However banks consistently reported increased availability of clean (uncollateralised) trade lines in the pre crisis period.

TFP has been volume driven and as a consequence the bulk of its activity has been into markets, such as Kazakhstan, Russia and Ukraine, in recent years using the cash advance product. These are also the three markets which were heavily targeted by international banks and other providers of trade finance risk cover. Many banks, including most TFP banks, were willing (and able) to consider multiple sources of hard currency liquidity. The availability of liquidity was reflected in decreasing pricing.

3. Assisting participating banks in creating track records with international banks

One of the principal aims of the programme initially was to assist participating banks in creating track records with international banks and thereby restore or create networks between issuing banks in the countries in which the EBRD operates, and international confirming banks. During the Russian crisis, the majority of international banks had significantly cut or even closed their confirmation lines on virtually the entire banking system in the Russian Commonwealth of Independent States and to a lesser extent, to some of the countries in central and eastern Europe and south-eastern Europe. Consequently, local banks were cut off from risk capacity and therefore unable to maintain their trade finance activity at previous levels, causing their trade volumes to fall drastically at a time when countries were rebuilding their economic and industrial infrastructure. Banks considering entering the trade finance market were unable to do so during this time.

By signing up local banks under the programme and providing counter-guarantees to confirming banks, which were in the early days unwilling to take unsecured risk on issuing banks, local issuing banks were given access to trade finance lines and a network of relationships between issuing and confirming banks was established. The network is not, and does not need to be, very deep as issuing and confirming banks tend to deal with a limited number of banks and is also related to the preferred issuing and advising banks as determined by the importer and exporter.

The network building capacity is to be attributed solely to the guarantee product as cash advances are not relevant to creating track records and therefore have nothing to contribute to meeting this objective. As soon as the growth in guarantee transactions dropped in 2005, the active participating banking population stabilised or even decreased. Once the population of banks became stable, TFP's contribution to this objective was minimal. Therefore, TFP's efforts in assisting banks create track records was very strong in the beginning through the use of its guarantee facility suporting the creation of new networks for participating banks.

TFP must be given credit for their role in the fulfilment of this objective, but credit can only be claimed for the period when the networks were first established. There has been a tendency for TFP to repeatedly claim credit for track records and networks created in previous periods. In practice once the network has been established the role of the guarantee product becomes that of risk cover.

4. Strengthening the trade finance capabilities of banks

The final objective of TFP is to strengthen the trade finance capabilities of banks. Participating banks have been benefiting from learning by doing via regular contacts with the TFP team and/or confirming banks. This exchange of views and the linkages created with strong confirming banks has most certainly sharpened the trade finance skill of the local banks and is almost exclusively associated with the guarantee product rather than cash advances.

Participating banks have widely praised the professionalism and technical expertise of TFP team members and banks value their interaction with the TFP team. With the slowdown of new issuing banks joining the guarantee programme and longer standing participants reaching a level of experience and maturity, the marginal benefits of ongoing interaction have declined. . The arrival of international banks in many markets has reduced the blanket role for capacity building that existed at the outset of TFP. TFP activities have taken place outside of any strategic framework and can be described as piecemeal in nature. No strategic framework exists for specifying the role to be played by TFP in future trade finance capacity building.

Formal training and technical cooperation seems to have been directed towards the right set of banks and has generated a positive impact, especially around technical aspects. Although this is in the right direction, it is not obvious how significant the impact has been as there is a problem in identifying objectives and a strategy for technical co-operation, as well as in management reporting. Moreover, stabilisation of the population of active banks has resulted in a lower impact in the more recent years of the programme.

In pure volume terms it is apparent that TFP has been successful. Business grew rapidly since inception in all key measurement parameters (number of banks, number of transactions, value of transactions, intra-regional trade, country coverage and number of banks per country). However, the performance measures used by TFP give no guidance on achievement of objectives or resulting impact. TFP's approach to measuring success is based on "more is better". For example, the fact that TFP has an average of three to four banks per country does not provide an indication of the success or resulting impact TFP is having, or more precisely on whether trade has been fostered as a result.

Efficacy is rated as ***Marginal*** on the basis that the achievement of two objectives are considered not to have been achieved (foster trade and provide liquidity). Track records and capacity building are considered to have been achieved in keeping with the positive, if selective, findings.

In evaluating the extent to which TFP has fulfilled or is continuing to fulfil its objectives, there are fundamental issues over definitions of the objectives, target setting and performance measurement. *It is recommended that the opportunity is taken to fully restate TFP's strategy and redesign operational and transition impact performance parameters and monitoring processes.*

Impact - TFP's contribution to the Bank's transition impact mandate

The challenge in evaluating transition impact for TFP is that the transition objectives are virtually identical to the programme's operational objectives. Objectives are vaguely defined and open to interpretation. Measures of success are operational in nature and tend to reflect a "more is better" approach which is output based and no indication of transition impact. The transition approach is largely undifferentiated between programme participants (importers, exporters and their respective banks), direction of trade (import or export) or underlying goods.

The limitations of TFP's transition impact framework gives rise both to under recorded positive impacts, such as is happening with skills transfer, but also to unintended negative consequences which are not being captured under the monitoring framework, particularly through the requirement on banks under cash advances to collect supporting invoices and customs declarations that that are not reflective of the underlying loans to their customers. Fieldwork during the evaluation found that large amounts of documentation were being collected by the participating banks from end borrowers for TFP reporting but under loan facilities that were often general working capital purpose facilities, that had no such document collection requirements. The direct linkage with trade was therefore tenuous.

The key TFP transition impacts have been through bank linkages and subsequent deepening of the commercial relationship under the guarantee product, most crucially seen in new clean lines being granted. However, with the stabilising of the bank population and the network having been built, the level of guarantee transactions has declined (although has again seen a recent upswing during the financial crisis as confirming banks look for risk cover). Skills transfer has also been an important dimension, but all this is related to guarantee instruments. Cash advances are only a funding line and present no wider scope for transition due to the low level of conditionality required from the EBRD.

Transition impact under guarantee activities and capacity building alone is sufficient to merit an ex post rating of *Satisfactory* to *Successful*. However, cash advances were the dominant product for three years and are seen to generate marginal transition impact at best. On this basis the **Transition Impact** rating is limited to ***Satisfactory*** underpinned by historic guarantee and capacity building activities.

Efficiency

TFP financial performance is broadly in line with expectations (subject to credit losses now being incurred). The business model has been orientated to the fast turnaround and volume orientated nature of TFP transactions. Against this background, **Efficiency** is rated as ***Satisfactory***.

Implementation of TFP in EBRD policy and procedural context

Integrity and anti-money laundering

Prior to receiving a TFP facility, banks are subject to the EBRD's standard due diligence procedure including a review of integrity and anti-money laundering issues. At the transaction level, the approach has been largely to accept TFP transactions from participating banks at face value on the basis that the integrity and anti-money laundering process of the participating banks would have been applied prior to submitting the transaction to TFP. In this respect, TFP is not different from other credit lines of the Bank. However, unlike credit line products, the EBRD becomes directly attached to the paper trail for guarantee transactions and is therefore exposed to a higher degree of reputation risk, which should place a higher burden of scrutiny on TFP for integrity and anti-money laundering purposes. The sample file review of 165 transactions identified a concerning proportion of files that presented anti-money laundering issues or warranted further clarifications. On the basis of the transaction file review, the standards being applied by TFP are below market best practices of commercial banks.

Environmental procedures

TFP operates under the TFP environmental procedures, which are a subset of the environmental procedures for EBRD intermediated financing through local banks. The principle of the policy is to rely in the first instance on participating local banks to identify environmental risk associated with their activities, screen out any transaction on the environmental exclusion list and to identify any transactions that might be regarded as high risk for further consideration. There is an exemption from environmental screening for transactions defined as “commodity trade finance” with tenors of up to 12 months, regardless of transaction value and further exemptions for other transactions where a transaction is under US$ 5 million and less than one year.

A large proportion of TFP transactions are tailored to fit under these exemptions. However, there is no definition of what constitutes goods eligible for trade and commodity finance, commodities covered under the exemption and any issues of provenance. This presents the team with great latitude for interpretation. In a significant proportion of TFP files reviewed no rating was found, reason for exemption, or follow-up enquiry although the nature of goods as described would have warranted it. Some transactions would be right up to the limits above which Board approval is required (US$ 20 million) or apply a one year tenor, which would exempt them from risk rating if they were treated as commodity trade finance (for which there is no record on file if this was the reason for not rating). *Recommendation is made that TFP environmental procedures are updated to provide guidance on the definition, commodities exempted and any issues of provenance of commodities related to the exemption from risk rating under commodity trade finance definition. All transaction files should record clearly the environmental categorisation, reason for exemption and rationale applied.*

Integration between TFP and other similar EBRD credit lines

There needs to be much better integration between TFP and other similar EBRD credit line products to banks that include sub loan eligibility for trade finance. Small to medium size enterprise (SME) credit lines, for example, typically offer a lower level of conditionality for a transaction that could equally be allocated to TFP (no substantiating trade documentation required for SME credit lines) and banks therefore allocate transactions to the lines with the lowest level of conditionality first. It would be good practice to coordinate between TFP and SME facilities made available to the same bank so that the opportunity for arbitrage between the two facilities is minimised.

During the field interview programme, it became clear in one particular country that trade finance transactions were routinely structured to allow customers to avoid paying customs fees and (subsequently) corporate income tax. Goods entered in the black economy and stayed in the black economy, contributing to a lack of financial transparency. TFP banks equally participate in this market practice and utilise TFP guarantees in the transaction process. In other cases TFP guarantees have been used to support transactions that are tax minimisation schemes, where the real physical movement of goods is highly questionable. TFP does not raise this type of issue with internal stakeholders (Opscom, Management, Office of the Chief Economist, Office of the General Counsel, Office of the Chief Compliance Officer and so forth) to ensure that engagement with banks transacting in this way is consistent with the Bank's approach to transparency and integrity issues in the countries concerned.

Delegation of authority from the Board

TFP operates under a framework of delegation of authority from the Board. This is an unclear and confusing collection of authorities and monitoring responsibilities that have developed over time. For example, cash advances over US$ 20 million require Board approval but guarantees, of any size, do not. In one case a guarantee transaction for US$ 44 million was approved by Opscom at the end of December 2009 supporting a public sector bridge building procurement in Turkmenistan. Construction was contracted to a Ukrainian construction firm. A state owned Ukrainian Bank, was to provide a performance bond on behalf of the Ukrainian contractor in favour of the Turkmen contracting authority. The EBRD would be guaranteeing the credit risk of the Ukrainian Bank. A transaction of this profile (publicly funded road construction, Turkmenistan to Ukraine, US$ 44 million of a US$ 150 million total procurement, relying on the procurement and integrity checks of Ukreximbank), would normally attract the interest of the EBRD Board. *The whole area of delegated authority and internal monitoring needs to be reviewed.*

Recommendations

The Study provides 20 recommendations regarding the future implementation of TFP. At the strategic level the view has been taken that after more than 10 years of operation and at least three fundamental shifts in operational emphasis, time is due for a fundamental reassessment of TFP objectives, strategy, business process and performance measurement. This is considered a priority ahead of the numerous individual operational recommendations that could be made on the current model. Recommendations include:

- TFP, in conjunction with Financial Institutions sector Bank Management and internal stakeholders, must draft a Strategy Paper revisiting all aspects of future implementation of TFP;
- The TFP product should be redesigned around the revised strategy;
- TFP must develop an agreed framework for measuring success that reflects the new strategy;
- A new approach to transition impact should be developed in consultation with the Office of the Chief Economist to accompany the restated strategy;
- Clear demarcation lines need to be established between TFP products and other overlapping products of the Bank;
- A task force should be established to unify the rules, authorities, limits applicable and monitoring processes and establish a single reference document for the multiple levels of delegated authority that exist for TFP;

- TFP must cooperate with Environment and Sustainability department to rectify deficiencies in environmental definitions and execution. Annex 4 of the TFP Environmental Procedures should be reviewed;
- TFP should develop a strategy and implementation plan for its technical co-operation activities;
- The current TFP approach to anti-money laundering and similar issues requires a comprehensive overhaul;
- FI should consider whether there is an opportunity to offer financing specifically for working capital purposes (which is how TFP cash advances have been used predominantly by participating banks) and make explicit product proposals to the Board as necessary;
- New implementation procedures must be prepared and implemented for post letters of credit financing to ensure use of proceeds for trade purposes.

The full study to this paper has not been published due to commercial confidentiality restraints. Please contact the EBRD Evaluation department if you require further information.

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