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## KEY POINTS

- Shortage of trade finance constrains micro, small, and medium-sized enterprises (MSMEs) from carrying out viable international trade transactions and to integrating them into global value chains.
- An average of 57% of the total value of trade finance applications by MSMEs in the Central Asia Regional Economic Cooperation (CAREC) region were rejected in 2018, more than the 33% experienced by MSMEs in other Asian economies.
- The region's MSMEs experience difficulty getting trade credit due to their poor financial standing along with their lack of formal documentation.
- The region can tap financial technology (fintech) to cater underserved trade finance needs of smaller businesses. CAREC countries, in collaboration with private partners, need to update their financial, regulatory, and technology infrastructures toward fintech development.
- Efforts include digitizing and automating business processes toward improved management and efficient operations of traditional financial services. There is also a need for harmonized and improved information and communications technology (ICT) and digital infrastructure among CAREC countries.

## Leveraging Fintech for Central Asia's Trade Financing Needs: Supporting Underserved Micro, Small, and Medium-Sized Enterprises

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## INTRODUCTION

For decades, international trade has played a vital role in driving unprecedented economic growth in many emerging countries. Such an outcome could have been even more promising and inclusive if all viable trade activities were realized, but some are constrained due to adequate financing, particularly those from smaller businesses.

Kim et al. (2021) estimate around \$1.7 trillion in global trade finance shortfall in 2020. Amid the coronavirus disease (COVID-19) pandemic, the International Chamber of Commerce (2020) expects around \$1.9 trillion–\$5.0 trillion in trade credit is needed to facilitate a rapid recovery of global trade. Since international trade activity heavily relies on trade finance,<sup>1</sup> efforts should be devoted to addressing the market gap in disproportionately limiting trade and participation in the global value chain among smaller businesses.

Trade finance applications among MSMEs are more likely to get rejected relative to larger firms (Lee et al. forthcoming). Without the needed funding, potential cross-border transactions do not push through, making trade less inclusive.

This policy brief talks about the wider adoption of fintech in narrowing the trade finance gap in the CAREC region. It recommends policy actions to foster fintech adoption, grounded on efficient financial structures, effective regulatory frameworks, and the needed capabilities to advance inclusive trade and finance.

<sup>1</sup> The World Trade Organization (2017) estimates that trade finance facilitates around 80%–90% of international trade.

## UNMET TRADE FINANCING NEEDS IN CAREC REGION

Calculating from the Asian Development Bank (ADB) 2019 Trade Finance Gaps, Growth, and Jobs Survey, the average incidence of trade finance rejections (measured as a percentage of the total value of the company's trade finance application) of MSMEs in CAREC countries reached 57% in 2018, higher than the average of 33% experienced by MSMEs from the rest of Asia.<sup>2</sup>

### The challenge of trade finance shortfall is a mix of demand and supply issues.

MSMEs in CAREC often fail to secure necessary trade finance due to insufficient collateral or guarantees. Many MSMEs experience difficulty getting bank credit due to lack of reliable audited financial statements and formal documentation. This situation will persist unless there is a system that can provide credit assessment even with the lack of financial information, such as through big data and machine-learning systems.

For lenders, on the supply side, trade finance applications from smaller businesses often get rejected because such transactions involve high transaction and information costs in complying with anti-money laundering and “know your client” (KYC) requirements. For example, the operational cost of issuing letters of credit and guarantees involving MSMEs is relatively high. Also, the financial sector caters less to transactions that appear to involve greater risk and lack digital presence, which is common among smaller businesses with infrequent and small-ticket transactions.

### Slow progress in financial sector development in many CAREC countries impedes overall financial inclusion among MSMEs, including adequate trade finance.

With the exception of the People's Republic of China (PRC), financial development in other CAREC countries remains low, constraining MSMEs' access to finance, including funds needed to facilitate their trade activities. The PRC has made substantial improvements in developing its financial markets through aggressive efforts in tapping advanced technologies. Auboin and DiCaprio (2017) posited that having a strong financial system would help countries efficiently handle trade finance transactions.

Well-functioning and advanced financial markets also allow firms to diversify their savings and raise money through stocks, bonds, and wholesale money markets, circumventing challenges from traditional bank lending. To date, however, financial development in other CAREC countries remains subdued by weak financial market frameworks, along with the slow improvement of the traditional banking sector with banks still primarily running on outmoded core banking technology.

### Retreats in correspondent banking in the region risk the potential of CAREC countries to provide access to safe, low-cost cross-border payment channels.

Correspondent banking plays a crucial role in cross-border payments, facilitating cross-border commercial transactions. Compared to East and Southeast Asia, correspondent banking remains limited in Central Asia. It is also exhibiting a further and sustained retreat over the past 6 years until 2019 (Committee on Payments and Market Infrastructures 2019). The withdrawal of global banks from correspondent banking relationships often relates to challenges in the capacity of local respondent banks. Respondent banks often fail to effectively manage risks linked largely to prudential requirements and to meet tax transparency standards (Erbenová et al. 2016). Rice, von Peter, and Boar (2020) warned that pressures leading to a withdrawal of correspondent banking relationships would raise the cost of cross-border payments and might drive businesses toward less regulated or even unregulated channels.

### National export credit agencies are absent in many CAREC countries.

The gap in trade finance is further complicated by the absence of national export credit agencies in many CAREC countries, including Afghanistan, Azerbaijan, Georgia, the Kyrgyz Republic, Mongolia, Tajikistan, and Turkmenistan (ADB and UNESCAP 2019). Export credit agencies are particularly suited to meeting the trade finance needs of smaller firms by facilitating lower financing costs, relative to commercial banks that extend short-term credit at market interest rates. A feasibility study funded by ADB technical assistance looks at developing a multilateral trade credit and investment (re-)guarantee agency in the Central and West Asia, East Asia, and South Asia subregions (ADB 2018).

## HOW FINTECH HELPS CLOSE THE TRADE FINANCE GAP

Part of the growing interest in fintech relates to its potential to overcome long-standing barriers, resulting in underserved MSMEs in financial markets. Empirical evidence suggests that the use of fintech can help lower the incidence of trade finance rejections, especially among smaller firms (Lee et al. forthcoming).

There are various ways fintech can help overcome challenges that have disproportionately affected smaller businesses in accessing trade finance. Fintech solutions transform risk and facilitate trade among MSMEs. Big data analytics and artificial intelligence (AI) allow financial service providers to reduce the cost of analyzing MSMEs' financial information and make credit decisions without formal documentation. Such cost is relatively high when

<sup>2</sup> The Central Asia Regional Economic Cooperation (CAREC) Program forms a strategic partnership of 11 countries: Afghanistan, Azerbaijan, the People's Republic of China, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan. Member countries espouse accelerated economic growth and poverty reduction especially through cooperation. Visit <https://www.carecprogram.org/> for more details. Following the government change in Afghanistan in mid-August 2021, ADB placed on hold its assistance in Afghanistan effective 15 August 2021.

transacting with smaller businesses, considering the small amount and infrequent transactions involved.

Fintech offers identity solutions to address challenges in KYC due diligence and new methods of credit risk assessment. Lee, Yang, and Kim (2019) argued that fintech could also improve supply chain finance efficiency by reducing the probability of misclassifying “good” firms as “bad.” Fintech allows MSMEs to transact via digital financial services, thus circumventing the lack of information and enhancing the risk management.

Some of the innovation- and technology-backed initiatives and efforts are found to have enhanced the efficiency and availability of finance, especially benefiting smaller enterprises. For example, the ADB-supported AI-enabled credit score system facilitated credit access to more than 8,000 small and medium enterprises (SMEs) in the Greater Mekong Subregion, with an amount of \$50,000 each through the end of March 2018. Using AI, the 310<sup>3</sup> online lending model of Ant Group has already served 29 million SMEs in the PRC, while maintaining a nonperforming loans ratio under 2%, even during the peak of the COVID-19 pandemic. Similarly, fintech in the form of cloud-based and branchless banking has been promoting greater financial inclusion in Indonesia and the Philippines.

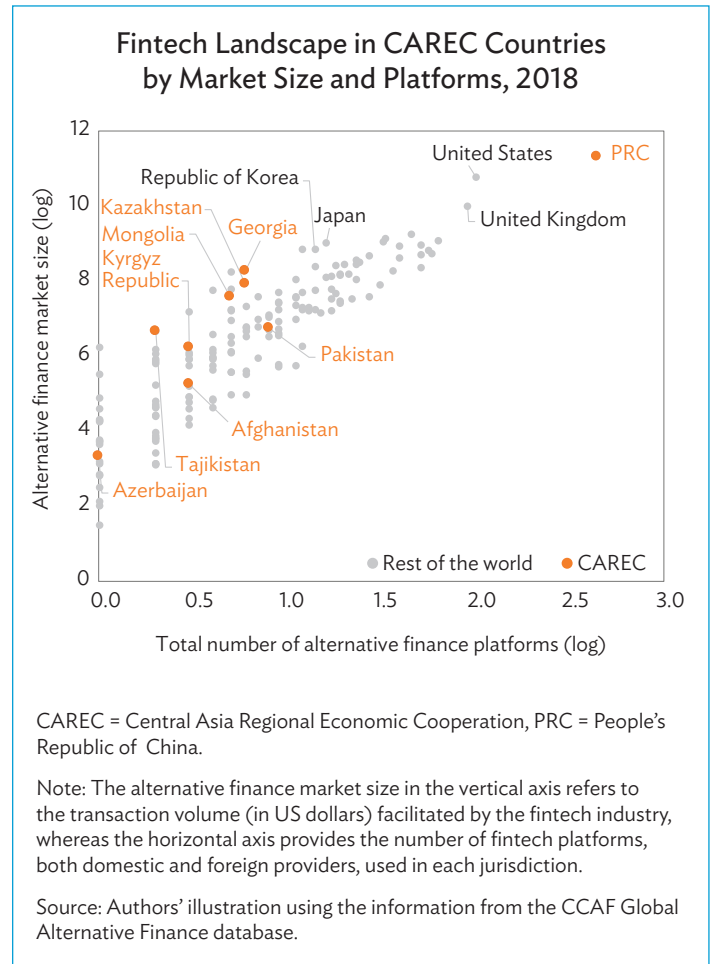
### FINTECH LANDSCAPE IN CAREC REGION

The CAREC region has much to gain from tapping fintech to potentially cater to the trade finance needs of smaller clients. However, the fintech ecosystem in the region remains dominated by the payments segment like “e-wallets.” Innovations leading to the emergence of regulatory technology,<sup>4</sup> trade processing, marketplace lending, and crowdsourcing remain in a nascent stage (Davletov et al. 2020). Digitalization initiatives leading to fintech development fail to push through due to, among others, the high cost of technology adoption along with the lack of international rules and standards covering digital trade.

Based on the Cambridge Centre for Alternative Finance (CCAF) Global Alternative Finance database, many CAREC countries are behind in the use of fintech, including the application for digitizing trade finance (Ziegler and Shneor 2020). The figure illustrates the relative infancy of the fintech market in CAREC, except the PRC, in terms of the market size and number of platforms. Georgia's alternative finance industry facilitated only around \$193 million in transaction volume in 2018, followed by Kazakhstan (\$87 million) and Mongolia (\$38 million). The rest of the member economies had even less than \$10 million in transaction volume, with the lowest recorded in Afghanistan (\$184,479) and Azerbaijan (\$2,222).

<sup>3</sup> The 310 model indicates that application takes only less than 3 minutes, while approval takes 1 second. Further, there is zero human intervention along the process.

<sup>4</sup> Regulatory technology, or RegTech, which is a subset and complementary to fintech, improves ways to effectively deal with the increasingly cumbersome compliance processes involved in the financial industry.



In contrast, during the same period, the fintech market size volume in the PRC totaled \$215.4 billion, accounting for more than two-thirds of the global alternative finance industry's total volume of \$304.5 billion. However, the PRC's market size decreased by 40% from the \$358 billion recorded in 2017, largely due to the closure of numerous peer-to-peer (P2P) lending platforms after the introduction of more stringent regulation around P2P lending in the country. It is also worth noting that 61% of the PRC's digitally active SMEs have the highest adoption rate in the world for using fintech services (Ernst and Young 2019). The country's advances in developing and applying payment platforms and big data management have created a new financial ecosystem.

## POLICY RECOMMENDATIONS TO HARNESS FINTECH SOLUTIONS

For the CAREC region to effectively harness fintech solutions to meet the underserved trade finance needs of MSMEs, member countries need to develop their financial, regulatory, and technology infrastructure and make it consistent with international best practices adopted in countries with advanced fintech systems.

### Strengthen focus on fundamental growth pillars.

In the short to medium term, CAREC countries should focus on building the known fundamental growth pillars of fintech. One critical element for establishing a solid fintech ecosystem is the availability of adequate human resources, which involves hiring, training, and retaining the best talents. Member countries should accelerate training of skilled fintech labor force in partnership with recognized higher education and research institutions. Kazakhstan, for example, has been proactive in developing talent in fintech and ICT-related sectors, e.g., the launch of programming schools like QWANT.<sup>5</sup>

The region needs to widen the coverage of ICT and digital infrastructure to include remote and rural areas and narrow the digital divide. The digitalization of trade finance enables more efficient and reliable processes and applications, thus reducing errors, improving data integrity, and accelerating the completion of agreements (Schaefer 2017). For example, eDocs streamlines processes by allowing multiple parties to access, review, and collaborate simultaneously. The region should intensify efforts to facilitate digital trade, shifting away from conventional trade clearance procedures while implementing “paperless” trade.

CAREC countries should also improve regulatory quality to support fintech development. Limited institutional support, lack of enabling legislation, unclear business environment for fintech products, and unstructured government and regulatory strategy on digital financial services are consistently identified by member countries as the key factors that limit fintech adoption and innovation in the region. A comprehensive review of the legal and regulatory framework needs to be initiated through a multistakeholder approach involving regulators, policymakers, financial sector institutions, and fintech players. Specific to trade finance, the region should seek to harmonize digital standards in the financial and trade sectors and promote best practices involving detailed data analysis, benchmarking, trend analytics, and advocacy.

### Forge deeper strategic collaboration through the CAREC Program.

From a regional cooperation perspective, challenges lie in strengthening regulatory structures and ensuring that they are sufficiently harmonized across CAREC countries despite differences in the levels of fintech sophistication.

The CAREC Program can be a platform to support member countries to achieve legal and regulatory harmonization, whereas fostering knowledge and policy dialogue to strengthen access to finance by promoting a regional CAREC market based on fintech. In partnership with ADB and the CAREC Institute, the CAREC Program, through the Regional Trade Group, can develop a progress roadmap for fintech, including the establishment of an innovation hub to further develop expertise and drive innovation in the region. In particular, the roadmap can discuss institutional and legal frameworks needed to ensure the consistent application of fintech across CAREC countries.

To facilitate the regional expansion of fintech, regulators and policymakers in different jurisdictions would need to cooperate to create a so-called “cross-border regulatory sandbox” or to introduce a “fintech passport” to promote financial innovation and fintech development. A forum similar to the ASEAN Financial Innovation Network, which includes relevant partners and stakeholders, could be initiated among CAREC countries to improve the cooperation and coordination of national regulatory bodies supporting the growth of the fintech industry.

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<sup>5</sup> QWANT is an online tech school that currently focuses on software engineering, data science, and designing complete web applications and websites.

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