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KEY POINTS

- Global adoption of the Legal Entity Identifier (LEI) could be transformative.
- The LEI is a code that verifies who is who and who owns whom. In the future, it will also verify who owns what.
- Banks with an LEI provide more certainty in customer onboarding credit approval and transaction processes.
- LEI can drive more transparency and underpin the promise of fintech to deliver greater inclusion of small and medium-sized enterprises in the global economy.

Trade and the Legal Entity Identifier

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OBJECTIVE

This brief aims to inform the market of the important role that a Legal Entity Identifier (LEI) can play in trade. The LEI can drive more transparency and underpin the promise of fintech to deliver greater inclusion of small and medium-sized enterprises (SMEs) in the global economy. Global adoption of the LEI could be transformative.

TRANSFORMING INTERNATIONAL TRADE

Finance enables about 80% of global trade through secure payment solutions, a range of financing options, and risk mitigation techniques that make trade viable in even the most complex markets. Trillions of dollars in annual trade flows could not take place without trade finance. At the same time, risk and compliance issues, as well as cost, contribute to a persistent level of unmet demand for trade finance, leaving a gap of about \$1.5 trillion annually.[1]

[1] K. Kim et al. 2019. 2019 Trade Finance Gaps, Growth, and Jobs Study. *ADB Briefs*. No. 113. Manila: Asian Development Bank (ADB). September. https://www.adb.org/publications/2019-trade-finance-gaps-jobs-survey; A. Di Caprio, K. Kim, and S. Beck. 2017. 2017 Trade Finance Gaps, Growth, and Jobs Survey. *ADB Brief No. 83*. Manila: ADB. September. https://www.adb.org/publications/2017-trade-finance-gaps-jobs-survey.

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Contributing to this market gap is an inconsistent patchwork of national regulations for due diligence and Know-Your-Customer (KYC) requirements, which are designed to ensure companies accessing the financial system are not laundering money and financing terrorism. While it is critical to ensure criminals are not using the finance system to perpetrate crime, this tangle of regulations is becoming increasingly difficult for financial institutions to navigate. Also, trading partners can be located in countries where certain fundamental tools critical to the conduct of due diligence—a trusted credit bureau, audited financial statements, perhaps even internet connectivity—are inadequate, unreliable, or simply unavailable. When confronted with these KYC and due diligence challenges, financial institutions may simply decide not to transact with companies, especially, SMEs, rather than go through the onerous and uncertain processes required by the regulations. These factors all contribute to the sizeable trade finance gap.

THE LEGAL ENTITY IDENTIFIER

The Global Legal Entity Identifier Foundation has created an identification system to change the way people do business, evaluate risk, and lend money. The LEI system was established in 2014 as a harmonized global standard by the Group of Twenty in the wake of the financial crisis, with oversight provided by the Financial Stability Board.

The LEI is a unique, electronic, 20-digit standard identifier for legal entities, including financial institutions, major corporations, governments, and SMEs. Just like a passport or a car registration number, the LEI represents a common and recognizable code. Relevant reference data are easy to access, making it easier to identify legal entities and verify their status.

HOW THE LEGAL ENTITY IDENTIFIER CAN HELP

LEI can address regulations on KYC and due diligence because it can be used to identify a legal entity quickly and unambiguously.

The LEI can likewise serve as an anchor to ensure that other identifiers containing additional information can be secured. For example, the LEI and the Business Identification Number code are already mapped onto each other and provided by the Global Legal Entity Identifier Foundation on its website. The LEI and other identifiers, like the International Securities Identification Number code, are also being mapped.

For trade, therefore, the LEI could be transformational by allowing more certainty in customer onboarding and credit approval processes; and to smooth the way through the multiple checkpoints in the typical life cycle of financial and real economy transactions. In correspondent banking, using the LEI could greatly facilitate the provision of financial services to emerging economies and SMEs. In a 2017 paper, consulting firm McKinsey & Company. concluded that banks could "potentially collectively save between $250 million to $500 million per annum if LEIs were used to identify international entities and to automate the tracing of their history for the issuance of letters of credit."[2]

More specifically, the LEI can help achieve the following:

(i) Trade financiers will be able to validate the identity of potential clients, overseas counterparties, and service providers, contributing to a robust due diligence process and reducing commercial risk as well as risks of fraud, money laundering, and terrorism financing.

(ii) Reduce fraud at the transactional level, potentially enabling financiers to better detect duplicate invoices by associating an LEI to each financing request. It can also clarify the link between trade finance mechanisms like Documentary Letters of Credit and specific parties, and by capturing the LEI in the structured Society for Worldwide Interbank Financial Telecommunication messages used to transmit these instruments around the globe.

(iii) Enhance Anti-Money Laundering and Countering Financing of Terrorism practices through more efficient and specific data extraction and analysis, thereby reducing instances of "defensive compliance" that contribute significantly to the trade finance gap. Capturing an LEI in a Suspicious Activity Report/Suspicious Transaction Report, for example, can enhance analysis by financial intelligence units and raise prosecution rates achieved through Suspicious Activity Report and Suspicious Transaction Reports globally.

(iv) Support innovation and the digitization of trade finance by providing for high quality, standardized data to identify the parties engaged in trade finance transactions.

(v) Reduce incidences of "false positives" in compliance activity.

(vi) Enhance visibility across, and standardization of, trade transactions end-to-end.

(vii) Improve the ability to identify patterns in Anti-Money Laundering and Countering Financing of Terrorism issues in trade finance.

A detailed review of relationships, processes, and transaction lifecycles will help identify other key areas where the LEI can drive access to trade finance and advance trade-based economic growth and inclusion.

THE WAY FORWARD

The use of the LEI in all aspects of the financial market is growing, including in payments and supply chain processes. Some of the growth is driven by regulatory requirements, while some growth is driven by the private sector. Initiatives, such as the addition of LEI

[2] McKinsey & Company. 2017. *The Legal Entity Identifier: The Value of the Unique Counterparty ID*. October. https://www.mckinsey.com/industries/ financial-services/our-insights/the-legal-entity-identifier-the-value-of-the-unique-counterparty-id.

[3] https://www.iso20022.org/

to Society for Worldwide Interbank Financial Telecommunication payments messages (ISO 20022) and, over time, to trade finance messages (Category 4 and Category 7 messages) will further expand the use of LEI in trade.[3]

Implementation of the LEI will require corporates and banks to develop features in their technology systems—including enterprise resource planning systems, trade systems, and core banking systems among others, to capture the LEI code and possibly the reference data.

Firms will need to consider strategically how to leverage the LEI as part of reference data management to reduce operating cost and improve risk management and compliance. This may include leveraging the LEI to facilitate KYC and Non-Customer Due Diligence processes. For example, LEI could be helpful in better identifying Ultimate Beneficial Owners where they are legal entities.

Given the rapid pace of change in financial markets, the time is now to consider introducing the LEI into processes related to trade finance. This can occur at individual institutions as systems upgrades are implemented, through regulatory mandate,[4] and through inclusion of the LEI in best practice documents that relate to the trade finance business.[5] It can also happen through the continued education and promotion of the use of the LEI in trade.

This paper, the McKinsey paper, and the Asian Development Bank's study, *Legal Entity Identifier Accessibility: A Survey by the Trade Finance Program*, are three examples of such educational communications.[6] Also, recent papers in the *Journal of Payments Strategy & Systems* and the *Journal of Securities Operations and Custody* provide a wealth of information about the LEI in payments and trade as well as specific suggestions on the way forward.[7]

4 For example, in November 2018, the Bank of England published its *ISO 20022 Consultation Response Paper: A Global Standard to Modernize UK Payments* requiring the use of the LEI, as did Malaysia in October 2018, as part of their large value payment system account opening and documentation process.

5 The International Chamber of Commerce has recommended that the Group of Twenty adopt legislation requiring LEIs for all trading companies.

6 S. Beck, J. Hyde, and C. Laysa-See. 2019. Legal Entity Identifier Accessibility: A Survey by the Trade Finance Program. *ADB Briefs*. No. 109. Manila: ADB. https://www.adb.org/publications/legal-entity-identifier-accessibility-tfp-survey.

7 M. Knorr. 2018. The Emerging Influence of Legal Entity Identifiers in Payments. *Journal of Payments Strategy & Systems*. 13. pp. 47–53. https://www.researchgate.net/publication/332625183_The_emerging_influence_of_legal_entity_identifiers_in_payments; J. Metzger and T. Paulowitz. 2018. Seeking Common Legal Entity Standards to Facilitate Cross-Border Payments. *Journal of Securities Operations and Custody*. 12. pp. 365–370. https://www.researchgate.net/publication/332569516_Seeking_common_legal_entity_standards_to_facilitate_cross-border_payments. PMPG paper, https://www.swift.com/about-us/community/swift-advisory-groups/payments-market-practice-group. Payments Journal (subscription needed), https://www.ingentaconnect.com/content/hsp/jpss/2019/00000013/00000003.

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