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Trade finance pursuing institutional investor funds

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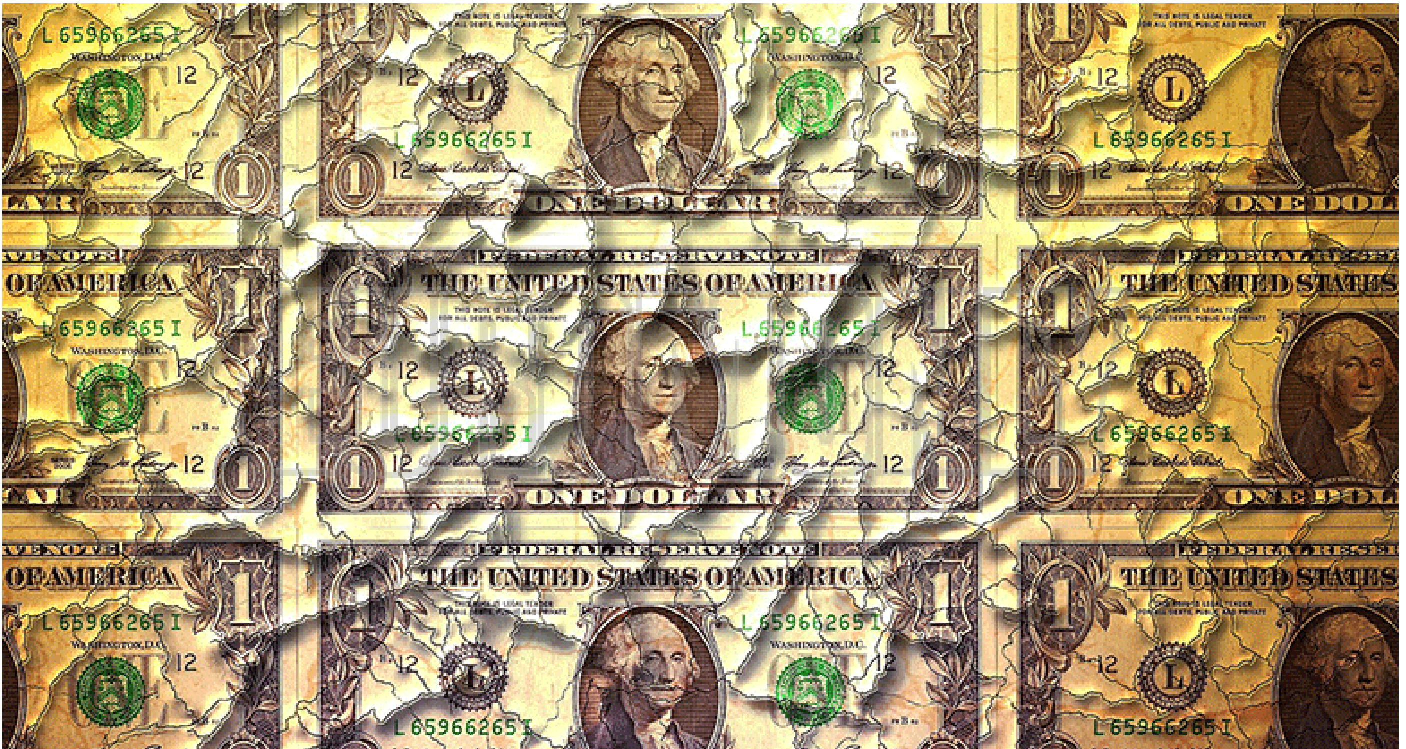
Trade finance has emerged as an asset class with appeal for institutional buyers, but needs to have some issues ironed out before it becomes palatable to a broad investor base.



With equity markets selling off again in March and risk-free rates declining once more, discovering any asset class with positive returns and a low default rate could be of interest to institutional investors.

The Trade Finance: A Promising New Asset Class for Institutional Investors report produced by Greenwich Associates on behalf of EFA Group, points out that trade finance offers the possibility of between 3.5% and 5% net returns.

Does that compensate for the risk? The ICC Trade Register 2017 finds that between 2008 and 2016 the default rate on import letters of credit stood at 0.38%, and on export letters of credit at just 0.05%.

While some institutional investors are already looking at trade finance, the market is now ripe for development.

Deep Singh, EFA Group

Deep Singh, head of investments at EFA Group, says: “While the asset class is relatively small, it has been around for about 15 years now and has evolved over the last few years. There are now more than 20 viable asset managers for institutional investors to consider.

"Their collective assets under management has grown from under $5 billion in 2015 to more than $7 billion.”

Although these numbers are on the up, they pale in comparison both to the sums of trade finance that are provided by the banks, and what is being invested by the institutional investor base as a whole elsewhere.

Christoph Gugelmann, co-founder and CEO of trade finance investment marketplace Tradeteq, says: “At present, there is $9 trillion in bank financing in trade finance, but only $25 billion of that is coming from institutional investors. This is compared with capital market bonds, where the institutional investors are doing about $29 trillion of investments.”

What makes the potential development of the asset class interesting is the scope of the possible investor base.

Olivier Paul, head of policy at the ICC Banking Commission, says: “There is not a limited list of potential investors. However, insurance companies, pensions and investment firms could be the most obvious category of investors.”

The very nature of trade finance investments fit well with current appetites, says EFA's Singh.

“Low correlations to long-term interest rates and other fixed income strategies and the consistent risk-adjusted return profile of trade finance investments mesh well with institutions’ current investment strategies, which could help investors achieve important goals within their portfolios,” he says.

It is also a good option for the banks, as it fits in with their current operational practices. ICC’s Paul says the originate-to-distribute model the banks operate with trade finance makes it an ideal proposition for investors.

Tradeteq’s Gugelmann agrees, saying: “The bank originate-and-distribute model has an ideal home in this space. Bank and non-bank originators can upload specific portfolios and information to Tradeteq, and present these to potential funders.

"For investors, they can compare various opportunities through data standardization, reporting and advanced analytics. It gives them a better understanding of the transaction and helps to make the decision to invest.”

However, to convince investors they are getting a good deal, Gugelmann says banks have to outline the quality of what they are investing in.

“We have to show investors they haven’t received the poorest part of the portfolio," he says. "The current process of managing trade finance information for analysis is manual, error prone and takes time. There needs to be a move from spreadsheets to an intuitive, transparent and easily accessible way of preparing and presenting the information.”

Institutional money

Crucially, the arrival of more institutional money might help to even out the availability of trade financing.

Paul says: “The emergence of new investors in trade business will create a real benefit by increasing the funding capacity, allowing more distribution of assets.

“More attraction on trade business and more investors would also help with reducing the trade finance gap. With an estimated amount of $1.6 trillion, it is likely that the sole banking system cannot fill this gap.”

In particular, it could be helpful to those companies that already struggle to obtain bank financing.

Gugelmann says: “The overall lack of SME financing is $6 trillion, and trade finance only accounts for about 7% of external financing provided to SMEs globally. Banks can’t take on the SME risk, but the institutional investors can. We want the capital to bring the benefits to the SMEs.”

While this all might sound appealing to the trade finance market, it will not be a quick fix. Even if some investors are showing interest now, it does not mean they will be able to enter into the market overnight.

Markus Ohlig, managing director at Greenwich Associates, says: “Trade finance is not a class on the radar of investors – they don’t know much about it. Institutions require work and due diligence before they can adopt it as an asset class. It could take up to 18 months for it to pass the scrutiny of the investors and be available as an investible asset.”

Markus Ohlig, Greenwich Associates

Getting institutional investors to understand just what they are investing in might prove to be a stumbling block. The Greenwich report puts the hurdles that need to be climbed bluntly when it outlines that 30% of respondents had only heard about trade finance for the first time when they were approached to answer questions for the survey.

Even for those who do know of it, there are still more complexities to figure out. For a start, there is no global standardization in the terms used in trade finance, despite the efforts of groups such as the ICC to implement this.

Singh says the issue of standardization is something the industry is trying hard to resolve.

“A few years ago, if you had 10 trade finance experts in a room and you ask them for the definition of supply chain finance, you’d probably end up with 11 answers," he says.

"Once you have a level playing field and that consistency of understanding of what exactly a product is, then you can take it externally to the market and ask if they want to invest.”

This is a two-way issue, as the Tradeteq Technology for Transparency report notes that trade financiers will also need to learn the language of investors who are unfamiliar with trade finance.

Complications

Further complications might come from the way investors define which assets they choose to invest in.

Nils Behling, co-founder and CFO of Tradeteq, says: “Investors want to know more about the risk profiles of the companies they are dealing with, and want updates on whether they are a good or a bad company to be working with. With this information, they can price the risk accordingly.”

Greenwich Associates' Ohlig says: “The lack of a rating system may put some investors off. There needs to be a credible alternative to ratings for investors to understand the potential risks.”

However, there does not seem to be any form of rating system in the works that could be applicable.

Investors might have to modify their expectations from an asset that can mature in just 60 days.

Olivier Paul, ICC Banking Commission

Says Paul: “The short-term nature of trade finance offers a different average maturity landscape compared to average maturities usually contemplated by investors. The renewal mechanism of such assets in a portfolio in which an investor takes a participation will have to demonstrate a maintenance of the same level of risk on the full maturity of the investment.”

Tradeteq's Behling says they would also need to understand the continuous nature of investments, adding: “Trade is made up of short-term, self-liquidating assets, but you need to replenish the pool to generate investment exposures that are not just periodically reverting to cash as these assets roll off.”

Some investors might need to do considerable know-your-customer checks into what they are investing in to meet their own criteria.

Ohlig says: “Issues may arise in the self-regulation of companies. There are big considerations around ESG. Companies will want to manage the risk around this and understand what they are actually investing in before they pay in any funds.”

However, there is hope.

The Greenwich report pointed to European institutions having the capabilities to tackle on-boarding a new asset class. Around half of the companies it surveyed stated they invested in securitized and real-estate loans, which, the authors suggest, indicates a “high degree of familiarity with less liquid credit investments – a potentially important factor, given the illiquid nature of trade finance investments”.

Further, 63% stated they had experience in emerging markets, which make up a substantial proportion of trade finance.

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