Trade Finance: The Rise of an Asset Class

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We live in a globalized world, one in which is underpinned by domestic and international trade. Global merchandise exports reached just over US$ 17 trillion in 2017 and have been consistently growing at 1.5 times the rate of GDP other than a handful of anomalous years.

Looking back to 2017, when the latest available data on global trade was documented, world merchandise trade recorded its strongest growth in six years.

Significantly, the ratio of trade growth to GDP growth returned to its historic average of 1.5, which is far above the 1.0 ratio recorded in the years following the 2008 financial crisis. This data supports the view that trade plays a crucial role in driving economic growth, development and job creation around the world.

Trade has expanded as a result of greater growth taking place across most regions of the world. Furthermore, developing economies are what is driving this expansion at such a great speed.

In 2017, imports of developing countries grew faster in value than those of developed economies. Imports of developed countries increased by 13%, whereas exports from developing countries grew by 12%.

Furthermore, the share of developing economies in the world trade reached just over 43%, a recent high. Interestingly, more than half of this trade takes place with other developing countries, with an increasing share of trade in manufactured goods.

Focusing on Africa, the share of its merchandise exports within the continent has nearly doubled, jumping from 10.3% of total exports (by value) in 2010 to 19.6% in 2017. At the same time, the continent saw record growth in international tourism revenue. This increase has contributed to its economic growth while supporting poverty alleviation, thereby advancing progress towards the United National Sustainable Development Goals.

It is estimated that circa 80% of global trade is bank intermediated, making it one of the largest potential credit asset classes. This dwarfs the leveraged loan market, among others. Despite its obvious power, Trade Finance is still a somewhat mystery asset class to many institutional investors.

Trade Finance is a specialised area of financing that is tailored to support domestic and international trade. When trading goods, there is typically a time lag between the dispatch of goods by the seller and the corresponding receipt issued by the buyer. Normally, sellers require payment upfront or at dispatch, whereas buyers prefer to pay upon arrival.

In its simplest form, Trade Finance reconciles these timing lags by providing a short-term customised credit facility. These are generally intermediated by specialised third party financial institutions, such as banks, factoring houses or private credit funds.

Unlike traditional credit that is built on a bilateral agreement between the lender and borrower, Trade Finance involves three parties: the seller, the buyer and the financier.

This triangulation is one of the main factors explaining the low default rates in comparison to other forms of credit. In fact, neither the seller nor the buyer are incentivised to interrupt the transaction as doing so would have irreversible consequences on their businesses.

Multiple market studies conducted show that there is a significant and growing gap in Trade Finance availability, a delta driven by traditional lenders – i.e. banks refocusing or downsizing their activities and the corresponding growing demand from corporations of all sizes. This gap leaves a valuable opportunity for new lenders, and accordingly investors, to enter the market.

In 2016, this gap was estimated to be US$1.5 trillion, according to a global study conducted by the Asian Development Bank (ADB).

So, why is there a gap in the first place? Historically, Trade Finance transactions have been limited to being funded by banks and DFIs. However, Basel III capital reserve requirements, rising compliance and operating costs, ever increasing regulations and associated balance sheet constraints have caused banks to reduce their

exposure to Trade Finance. The impact of these limitations has been mostly felt by SMEs and Mid-Caps, particularly those in emerging markets where KYC and AML is more complex and costly. Simply put, these constraints have led banks to focus on financing larger clients.

The resulting exit of capital has created a new window of opportunity. Institutional investors can now participate in an asset class which differs from the more traditional forms of public and private debt (e.g.) corporate bonds, securitized loans/ABS, real estate loans, bank loans and infrastructure debt). This participation can be realised via specialised Trade Finance Funds or partnering with banks when it comes to larger transactions.

Trade Finance is seen by many as an attractive class and a welcomed addition to their investment portfolio. Especially when it comes to insurance and pension funds, this appealing asset class has six key features. Firstly, Trade Finance has low or negative correlation with other asset classes. Secondly, it offers diversification from more traditional asset classes, such as: corporate bonds, equities, fixed income, etc. The third benefit lies in the short-term nature of these transactions, with a typical average life being between 60 and 180 days. Given that each transaction is unique and finances a specific asset conversion cycle, as opposed to the borrower's general operations, these transactions are self-liquidating. Another feature lies in Trade Finance being characterized by low default rates of under 0.24% (as per the ICC Trade Risk Register 2017). And finally, increasing and floating returns for investing, as financing is usually LIBOR linked. Hence, as rates increase so does pricing.

In addition to being commercially attractive, global trade is considered central to achieving the United Nations Sustainable Development Goals (SDGs). The UN Agenda for Sustainable Development has set ambitious targets to be achieved by 2030 in areas such as poverty reduction, health, education and the environment. Trade Finance has its role to play in assisting to achieve this challenging quest.

In fact, the SDGs put significant emphasis on the role of trade in promoting sustainable development and recognize the contribution that Trade Finance is able to make to the 2030 Agenda.

As discussed above, trade has proven to be an engine for development and a powerful tool that can help in reducing poverty. It can realize this noble goal by boosting growth, particularly in developing countries. Rapid growth has already greatly contributed to the unprecedented reduction of poverty levels which resulted in the early achievement of the Millennium Development Goal to cut poverty in half by 2015.

Trade Finance has already attracted significant interest from many European and Asian pension funds. It continues to gather momentum as pension funds look for new ways to complement their strategies within the short-term credit space.

As knowledge of Trade Finance grows, this asset class will slowly but surely start to take the spotlight from more widely recognised private credit classes. This is inevitable due to its potential which is what makes it so appealing to the private and institutional investor community.