Global Trade Finance

Regulatory Change Opens Investment Opportunities

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Trade finance has long played a vital role in facilitating global trade by transferring risk, increasing capital efficiency and improving liquidity for businesses. Historically, this space has been dominated by the major banks. With the implementation of more stringent lending criteria (Basel III), many large banks have curtailed the growth of their trade finance portfolios or exited the area altogether. This has resulted in a large funding gap, creating an opportunity for private debt funds — and investors — to participate in an area that was once the sole preserve of traditional banks.

WHAT IS TRADE FINANCE?

> **Trade finance provides a credit facility to businesses to improve their cash flow and working capital and puts the company in a better positon to grow.**

Introduction

As the world becomes increasingly interconnected, global trade has become vital to the growth of the economy and to small and medium sized enterprises (SMEs). These SMEs are having to deal with new challenges, including subpar liquidity, cash flow, regulatory requirements, political instability and credit risk as they negotiate the many nuances of domestic and international trade.

Trade finance provides short term credit facilities to businesses to improve their cash flow and working capital putting the company in a better position to grow. Trade finance deals can also provide letters of credit or insurance to protect the parties from non-payment, counterparty risk or damaged goods.

What Is Trade Finance?

Trade finance represents a broad category of short-term credit facilities that companies rely on in order to participate in global trade. It provides credit to borrowers that need working capital to sustain their business.

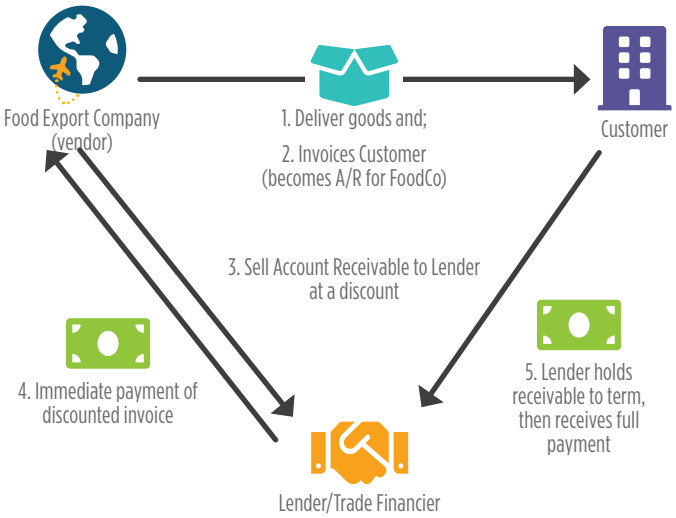
Loans provide borrowers the working capital needed to support manufacturing, processing, distribution and related activities. These loans typically range from 30 to 90 days, with annualized interest rates targeted in the mid to high teens (13% to 18%).

The most common forms of trade financing are factoring and supply chain financing.

Factoring

Factoring is when a vendor sells its accounts receivable (outstanding invoices) to a lender at a discount. This transaction provides the vendor with immediate cash and improves its working capital. The lender receives payment for the receivable directly from the customer. The lender's discount on the accounts receivable is earned because they assume risk of non-payment on the receivables.

Accounts receivable factoring



- **Outcome for borrowing company:** Quicker conversion of receivable to cash to fund operations and growth.

Example

Janice and her family run a food-exporting company from their farm in Alberta. When she ships goods to a customer, it can take as long as 60 or even 90 days before Janice gets paid. Rather than wait for customers to pay their invoices, Janice can factor her receivables through a trade financier (lender) and generate working capital much faster. Janice sells goods as usual, ships to her customers and invoices them directly. The trade financier will advance against the outstanding invoice less 10%. While the invoice is outstanding, an insurance policy on 90% of the original invoice is taken to protect against default. In this example, since the trade financier has advanced only 90% of the invoice, the transaction is 100% insured. Janice's customers then direct the payment of the invoice amount directly to the trade financier.

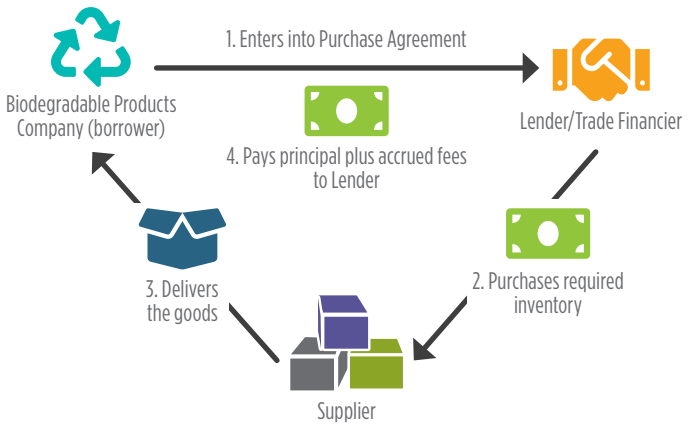
All parties benefit from the arrangement; however, the burden of trade financing fees lies with the vendor.

Supply-Chain Financing

In supply-chain financing, the burden of trade financing fees lies with the borrower. The lender purchases inventory on behalf of the borrower and then immediately resells it to them, creating an account receivable. The borrower pays the lender, plus fees, on the due date. Note that the lender doesn't actually take ownership of inventory, so there is no inventory risk.

Once again, all parties benefit. The supplier of goods gets paid immediately (by the trade financier) on the full invoiced price. The borrower receives the inventory immediately but extends the payable date. This creates a business advantage for the borrower by minimizing the upfront capital required to operate the businesses.

Supply chain finance



- **Outcome for borrowing company:** Better repayment terms and buying power than they could achieve on their own.

Example

Raj needs to purchase supplies for his company, which manufactures biodegradable products. Rather than purchasing directly from his supplier, he enters into a purchase and sales agreement with a trade financier (lender). The trade financier buys the inventory from Raj's supplier, has the goods sent directly to Raj, and then send him an invoice for the goods, plus fees. An insurance contract is also placed on 90% of the invoiced amount (original purchase price plus fees), protecting the original investment from borrower default. Raj pays the principal plus fees to the trade financier before the due date on the invoice.

Underwriting

As with any credit facility, underwriting plays a key role in trade finance. Similar to underwriting asset-based loans, where the primary focus is on the value of collateral and its collectability, trade finance transactions are evaluated in terms of the following:

Business/Industry

- Borrowers should be operating as a going concern in a stable industry and a track record of at least several years, with a recurring, high-quality customer base.
- Operational/financial procedures should be well documented and adhered to. Repayment controls must be in place to further reduce risk.
- A strong management team with a robust corporate structure is critical.
- There should be multiple exit strategies to ensure collection of the principal invested.

Financials

- The borrower should have strong financials and ratios with low risk of insolvency. Accounts receivable should have good payment history with short cash conversion cycles.
- Borrowers should not be highly leveraged.

Collateral and security

- To protect the principal invested, it is vital for the lender to be at the top of the capital structure which means the lender gets paid first in the event of a default or bankruptcy.
- Scenario and stress test analyses should be performed to estimate the value of the collateral in different environments.

Geography

- The lender needs to be aware of potential risks relating to trade tariffs/law and political uncertainty in certain regions.

Counterparty Risk

- Customer credit worthiness and payment capability of borrowers is critical to evaluating a trade finance transaction.

Mitigating Risk

Properly structured financing and strong legal documentation are critical to protecting lenders' interests. Certain risks that arise in trade finance transactions can be mitigated through:

- **First lien security interest against accounts receivable and/or inventory:** ensuring the lender gets repaid before all other debt holders.
- **Personal/Corporate guarantee:** a guarantee, generally by owners or related corporation, of payment for a loan in the event of default.
- **Validity guarantee:** a guarantee that the information submitted on borrowing base certificates or factored invoices is true and accurate. The borrower can be held liable for fraud or misrepresentation.
- **Confession of judgement:** a written agreement signed by the borrower (defendant) that predetermines and accepts liability and amount of damages. It is used to speed up normal court proceedings when borrowers default. This is valid only in certain states in the United States.
- **Credit insurance:** generally purchased by the borrower as insurance against non-payment by borrower's customer.
- **Cash dominion or lock box:** a control arrangement where the borrower's cash from payments against accounts receivables are sent to a bank account controlled by the lender.

Insurance

Insurance plays an important role in trade finance. It safeguards lenders against non-payment by borrowers and customers due to insolvency or bankruptcy. When borrowers request trade financing, lenders will generally work with an insurance company in parallel to their own underwriting process to ensure the transaction is fully insured. The insurance company will conduct its own due diligence on the borrower, determine their creditworthiness and if approved, assign a policy with credit limits. The borrower can request additional coverage on new buyers if required. The coverage terms will differ depending on the policy but generally range from 75% to 95% of the invoice amount for factoring transactions and principal (value of the purchase order), and accrued interest for supply chain transactions. Premiums are generally paid by the borrower.

When there is high risk of non-payment, the lender will establish a workout plan and file a claim with the insurance company for payment. The policyholder will generally pay the claim benefit within 60 to 180 days from the date of loss. Insurance companies typically pay the Loss Payee; Loss Payee on policies should always be the Lender.

MARKET OVERVIEW

> **The trade finance market is directly correlated to global trade flows as it facilitates commerce by reducing risk and improving liquidity.**

Trade: A fundamental part of economic activity, everywhere.

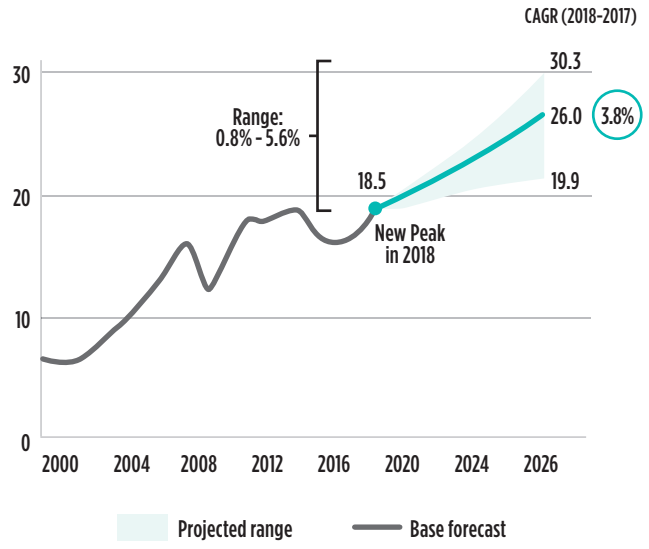
The past few decades have brought incredible changes in nearly every industry. Global trade is no exception as the world economy has experienced sustained positive growth, introducing significant opportunity for countries to benefit from increasing their trade flows.

Global Trade Flows

As the world economy has continued to develop and grow, so has global trade, with flows totaling USD$18.5 trillion in 2018. That number is projected to grow to USD$26 trillion by 2027. Even in a bear-case scenario, assuming lower GDP growth across mature markets and China and an annual growth rate in trade flows of just 0.8%, global trade flows are projected to reach USD$19.9 trillion.

The trade finance market is directly correlated to global trade flows as it facilitates commerce by reducing risk and improving liquidity. The International Chamber of Commerce approximates that trade finance facilitates 80% or more of annual trade flows. As shown below, this represents USD$524 billion in North America alone and close to USD$4.6 trillion globally.

Global trade flows in US$ trillion



Note: Forecasts are at constant FX rates.
Source: Boston Consulting Group (BCG) Trade Finance Model 2018.

	Traditional Trade Finance Total Value (USD$MM)	Supply Chain Financing (USD$MM)
Asia- Pacific	2,151,338	293,364
Africa	145,256	19,808
Central and Eastern Europe	293,121	43,800
Latin America	121,530	36,301
Middle East	506,894	56,322
North America	524,211	307,870
Western Europe	822,772	101,691
Total	**4,565,122**	**859,155**

Source: International Chamber of Commerce, 2018 Global Trade – Securing Future Growth.

Regulatory Change

The introduction of Basel III, a regulatory change that brought tighter capital requirements for banks, created a financing gap in the trade finance industry. Basel III is an international regulatory accord designed to improve regulation, supervision and risk management within the banking sector. It was first published in 2009 by the Basel Committee on banking supervision with an adoption window of three years from publishing. The bulk of the changes were in response to the credit crisis, leading to higher minimum capital requirements, which increased by up to 70% from Basel II.

Large financial institutions facing new capital constraints of Basel III have responded by reducing their exposure to trade finance and focusing on clients with the lowest possible compliance risk, leaving small and medium enterprises (SMEs) unable to access traditional financing sources. This funding gap creates an opportunity for institutions and investment funds in the space.

The Trade Finance Gap

A survey of 250 suppliers across 21 countries found that only 10% of the demand for supply-chain finance is being met. As shown in the chart below, the majority of the trading gap stems from Asia and Pacific and the Americas. As a result, institutional investors are very focused on Emerging Markets and to a lesser extent, the Americas, in search of yield.

Source: Mckinsey, "Supply Chain Finance: The emergence of a new competitive landscape", 2015.

$1.5 trillion trade finance gap – a global opportunity

Source: Insight Investments, The Trillion Dollar Trade Finance Opportunity, 2018.

Small and Medium Enterprises (SMEs)

SMEs make up the largest users of trade financing to operate their businesses. These organizations typically have less working capital and need additional short-term financing to pay suppliers and manage their businesses. The SME market is growing at an exponential rate accounting for, on average, 70% of total employment in OECD areas.

Source: OECD, Enhancing the Contributions of SMEs in a Global and Digitalised Economy, 2017.

Yet banks generally focus on the largest transactions in the market and tend to avoid SMEs given the complexity of compliance and the amount of resources required to complete a transaction. The Asian Development Bank ("ADB") Trade Finance survey estimates the global trade finance gap at USD$1.5 trillion in 2017 and estimates that almost three-quarters of rejected trade finance transactions are related to SMEs.

Source: Asian Development Bank Trade Finance Survey, 2017.

Advancement of Technology

Technology will continue to advance and disrupt many industries, and trade finance will likewise be affected. Processing transactions requires an abundant amount of resources and may involve multiple parties from around the world. Blockchain technology has the potential to eliminate inefficiencies in the process, increase closing speed and automate capital-intensive stages of the workflow including verification and reconciliation of records.

Global management consulting firm Bain & Company estimates that technological advances could reduce the global trade gap by approximately USD$1.1 trillion, increasing trade finance transactions accordingly. This opportunity could push larger banks to develop blockchain technology and smaller banks to partner with blockchain specialists. The decreased cost per transaction will make banks more competitive in this asset class, especially in the SME space.

Source: World Economic Forum, Trade Tech – A New Age for Trade and Supply Chain Finance, 2018.

However, blockchain technology is still in its early stages and requires substantial development before it is adopted more widely. In addition, banks will need to assess whether they want to make a large investment in this space and how such involvement affects their capital requirements under Basel III. As a result, technology's effect on the trade finance business is still estimated to be several years out.

INVESTOR CONSIDERATIONS

> **Participating in trade finance funds is one solution for investors seeking uncorrelated and higher risk-adjusted returns for the fixed-income portion of their portfolio.**

Investing in Trade Finance

Since the financial crisis of 2008-09, low interest rates have resulted in anemic return in the fixed-income market. Participating in trade finance funds is one solution for investors seeking uncorrelated risk-adjusted returns for the fixed-income portion of their portfolio.

Historically, trade finance has been priced anywhere between 50 bps and 800 bps above LIBOR. By comparison, commercial paper has typically returned 3 to 6 bps above LIBOR for the same 30- to 150-day exposure.

Source: Insight Investments, The Trillion Dollar Trade Finance Opportunity, 2018.

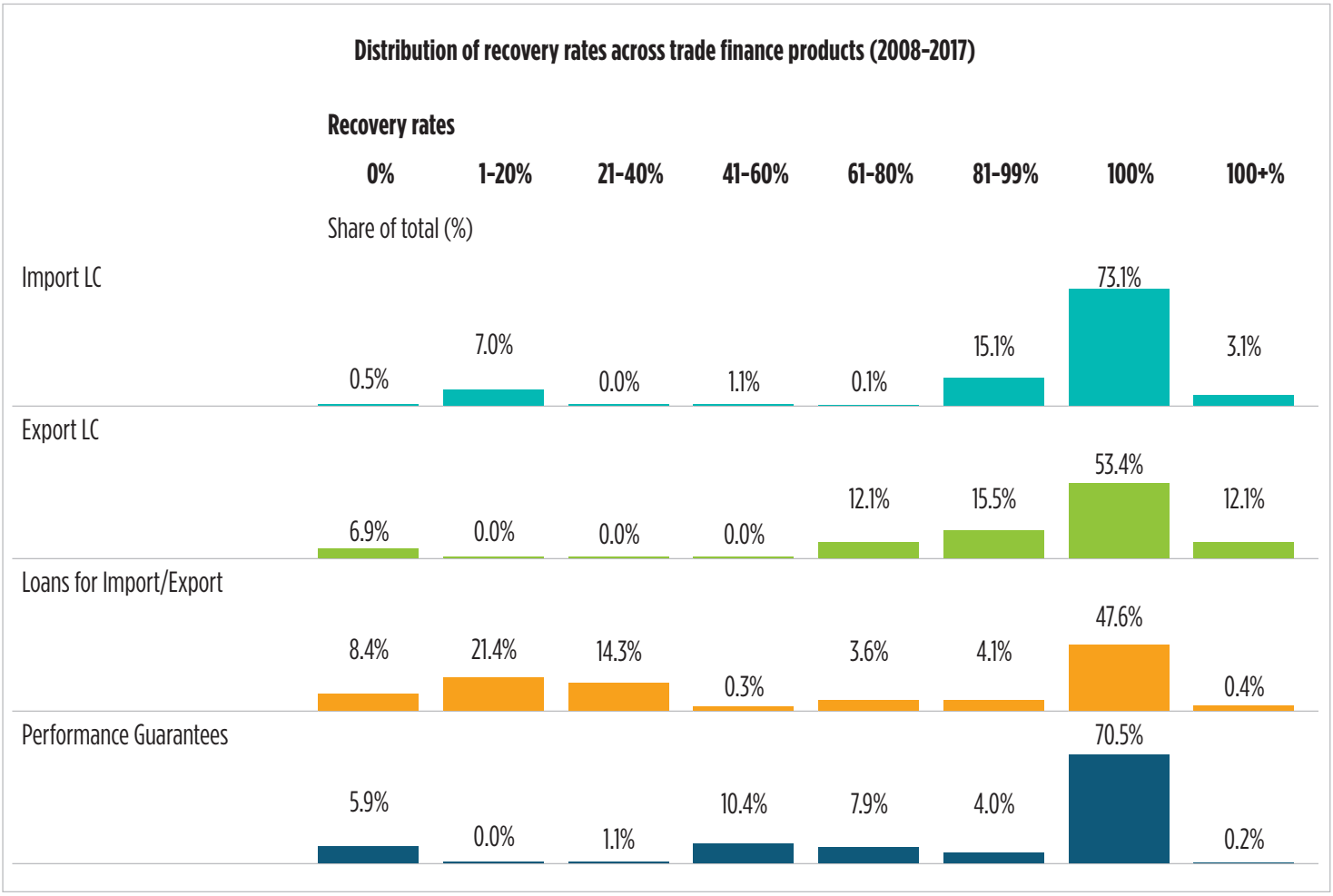
The Question of Risk

Trade finance lenders can charge borrowers higher fees to capture the increased risk and higher degree of due diligence required for such transactions. There is also a biased view that SMEs are all higher risk operations. Many are not and the primary reason banks avoid lending to these businesses is most often that they do not meet the banks' underwriting criteria, regulatory challenges and liquidity challenges. According to the International Chamber of Commerce, from 2008 through 2017, the default rate by exposure has been less than 26 bps (see table below). Even in default, trade finance products have historically high recovery rates, with most transactions achieving a minimum recovery rate of 81% (see graph on next page).

Total exposure and default rate by exposure, by product (2008-2017)

	Total Exposures (USD K)	Defaulting Exposures (USD K)	Default Rate by Exposure (%)
Import Letters of Credit	2,829,524,561	2,040,686	0.07%
Export Letters of Credit	1,677,581,599	496,472	0.03%
Loans for Import/Export	5,767,651,190	11,048,204	0.19%
Performance Guarantees	2,163,013,401	5,314,511	0.25%

Source: ICC Trade Register 2018.



Source: ICC Trade Register 2018.

Given that trade finance is based on trade flows, the product is cyclical in nature. Default rates are expected to increase during recessionary times. To further ensure principal is protected, it is essential to be senior secured with ample collateral coverage. Having credit insurance and personal guarantees further mitigates some of these risks.

In a strong growth environment, fixed-income products are more prone to interest rate risk. However, trade finance transactions are shorter in duration which typically mutes the impact of rate movement on an investment portfolio. In addition to being very low in duration, loans are generally priced at a higher rate (mid to high teens), which minimizes the effect of the underlying interest rate on the actual yield.

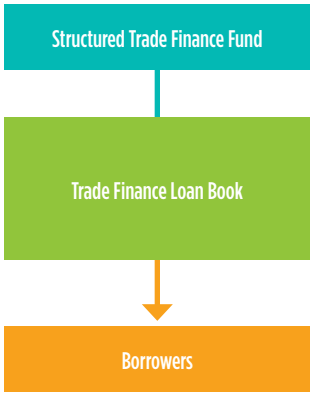
Liquidity is not a critical concern in the trade finance space. Trade finance transactions are made against self-liquidating assets that typically convert to cash in 30 to 120 days.

Methods of Access

Investors can access opportunities in trade finance through three avenues:

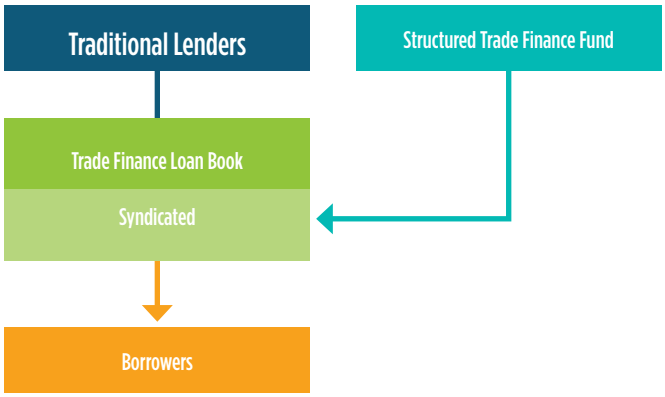
Replication

Replication occurs when an investor or investment fund seeks to directly recreate the banks' traditional trade financing activities on their own. By originating, underwriting and managing a portfolio of loans, the investor can achieve the full yield and return on investment that this strategy can deliver. This approach requires an expert team that understands the industry and regulations associated with the movement of assets between jurisdictions. Replication can also be costly and suffer from concentration risk if not enough capital is deployed to a diverse set of borrowers.



Participation

Participation is a form of trade finance investment that allows banks to optimize the risk structure of their trade finance loan book by selling a portion of their portfolio to investors. The investor gains access to a piece of the investment and thus achieves the sought- after yield by piggybacking on the bank's transaction infrastructure. However, participation is reliant on the bank's portfolio and its willingness to participate. As a result, the economics of the transaction are less favourable for the investor than full replication.



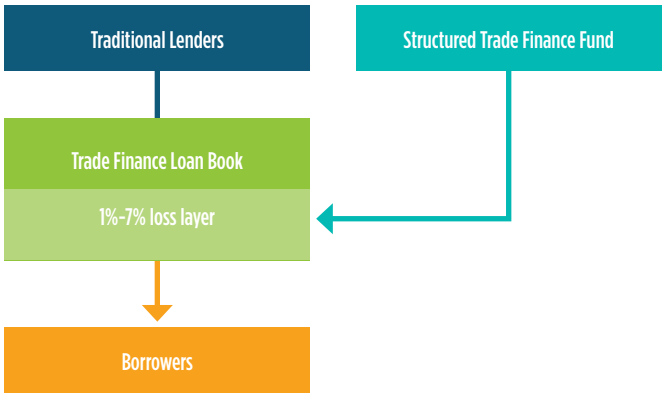
Regulatory relief

Regulatory relief investments allow for risk-sharing between investors and banks. The investor accepts a prespecified level of *first loss* on the portfolio.

A First-loss policy is a type of insurance that provides only partial insurance coverage.

This agreement passes some of the risk to investors in exchange for a portion of the returns. The high minimum investment, however, creates a barrier to entry for most investors.

For many individual investors, a replication model is likely to be the best choice as it requires less knowledge about the trade finance space. Once a preferred manager is identified, an investor can rely on his or her expertise. Generally, managers will provide investors with transparency, so there is full disclosure on the characteristics of the portfolio.



Source: Cambridge Associates, Trade Finance: An Expanding Opportunity for Institutional Investors, 2018.

Evaluating Trade Finance Managers

With many managers entering the trade finance space, it is important to identify those that are best-in-class to ensure strong risk-adjusted returns and prevent loan loss. The top-tier managers in this space should have the ability to source and maintain a pipeline of trade finance transactions, expertise in portfolio monitoring and experience with loan workouts and default.

Pipeline management. Without a sustainable and well originated pipeline, a manager will have difficulty deploying cash efficiently, and investor returns may be affected. The recent regulatory changes have resulted in a fragmented market where many transactions are originated through proprietary networks built on relationships. In order to build a sizable pipeline, the manager must have infrastructure and presence across various regions. It is vital for a manager to have reach, not only to replace maturing transactions but also to expand the portfolio. A large pipeline of transactions allows a manager to be more selective of their investments and sustain negotiating power in order to maintain strict covenants and higher yield.

Portfolio monitoring. It is crucial for managers to be proactive. Monitoring changes on every invoice requires significant resources and a manager must have a system in place to flag key risks. Look for a strong operational system that allows the manager to easily monitor their portfolio. The system should be built to handle the existing portfolio and accommodate growth.

Managing defaults. It is inevitable that managers will experience default, which is why they must have experience in workouts. Defaults and workouts can be quite complicated, and managers must have the knowledge and expertise to take the necessary steps. A strict workout process will help ensure the highest level of recovery in the most expedient manner. There should be minimal loan losses in senior secured trade finance given that it tends to be overcollateralized, protected with insurance and have short-duration, self-liquidating assets.

Conclusion

A rapidly changing market and increasing global trade flows have left a void to be filled in the SME space. For individual investors, replication models typically represent the best route to participate in trade finance investment opportunities, providing liquidity, given the short duration of the product. To achieve the strongest risk-adjusted returns, it is vital to select best-in-class managers with experience in the trade-finance space. Doing so will provide investors with a greater likelihood of achieving low correlation to public markets and strong diversification benefits to their portfolios.

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Sources:
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