tradeteq

TRADE FINANCE IN 2020

ASSET DISTRIBUTION – A MACRO-ECONOMIC NECESSITY

ITFA International Trade and Forfaiting Association

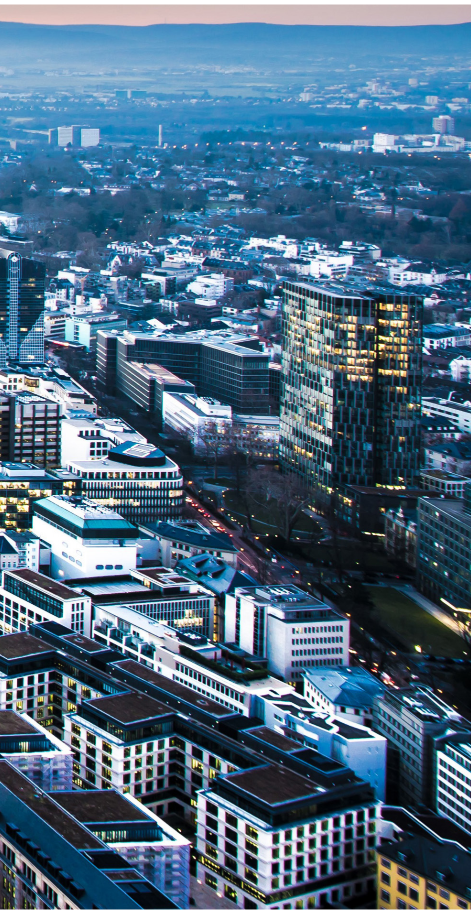
TFD initiative

Introduction

Long before Covid-19 pushed the world to the brink of recession, banks were already under pressure from regulations put in place after the last financial crisis. New Basel IV rules are putting ever more stringent requirements on banks and their ability to fund businesses. While large corporates continue to enjoy relatively easy access to funding, SMEs are facing an ever more growing global trade finance gap, estimated to be at least US$1.5tn.

Most of the world's economies have been forced into a shutdown that will last months and will have repercussions for years to come. Again, it will be small companies that bear the brunt of the slowdown, with many facing the threat of bankruptcy. Cash is king, and SMEs are having an even harder time accessing the necessary funding.

This is where trade finance asset distribution comes in. By selling these assets to non-bank investors, not only can banks remove risk from their balance sheets, but they can also find new avenues for growth. Additionally, opening trade finance assets to non-bank investors has the potential to unlock millions of dollars of new liquidity, helping to plug the trade finance gap and providing cash to the companies who need it most. Using cloud-based technology makes the distribution process more efficient, paperless, and independent of human intervention — a significant bonus at a time when the world is ruled by social distancing measures.



I. Long-term pressure meets historic crisis

It is no secret that bank liquidity has been under pressure for many years. After the collapse of the financial sector in 2008, regulations were put in place to ensure the risky behaviours that led to the crisis would be avoided. Tighter regulation require higher bank capital ratios, limits leverage and floors liquidity ratios. Additional rules are just around the corner, with the effective date now likely extended to January 1, 2023. This new set of modifications agreed in 2017, and commonly referred to as Basel IV, is causing controversy due to the extra pressure they are expected to place on bank capital. In a report on the impact of Basel IV on the European banking sector, McKinsey analysts pointed out that if banks did nothing to mitigate the cumulative impact of the new measures, they would need about €120bn in additional capital, and the banking sector's return on equity would be reduced by 0.6 percentage points.

According to the World Bank, SMEs represent 90% of businesses and more than 50% of employment worldwide. SMEs contribute up to 40% of national income (GDP) in emerging economies. The World Bank estimates that 600 million jobs will be needed by 2030 to absorb the growing global workforce, making SME development a high priority for many governments around the world.

In late 2019, the International Finance Corporation (IFC) published a global survey on SME banking, revealing the biggest challenges encountered by banks in the segment. More than half of the survey's respondents indicated that credit is the top challenge in SME finance, while a third named external factors such as macro-economic environment and government policy changes. Other challenges included technology adoption, client engagement, and competition. To address these challenges, more than half of the respondents said that they would invest in technology as a priority.

An unprecedented emergency

These challenges have been exacerbated by the Covid-19 outbreak with many small companies have been ordered to stop activities, placing them in need of emergency liquidity in order to pay salaries and fixed expenses. At the same time, banks are under pressure too, facing volatility and preparing to weather a financial downturn that will be worse than the 2008 global financial crisis.

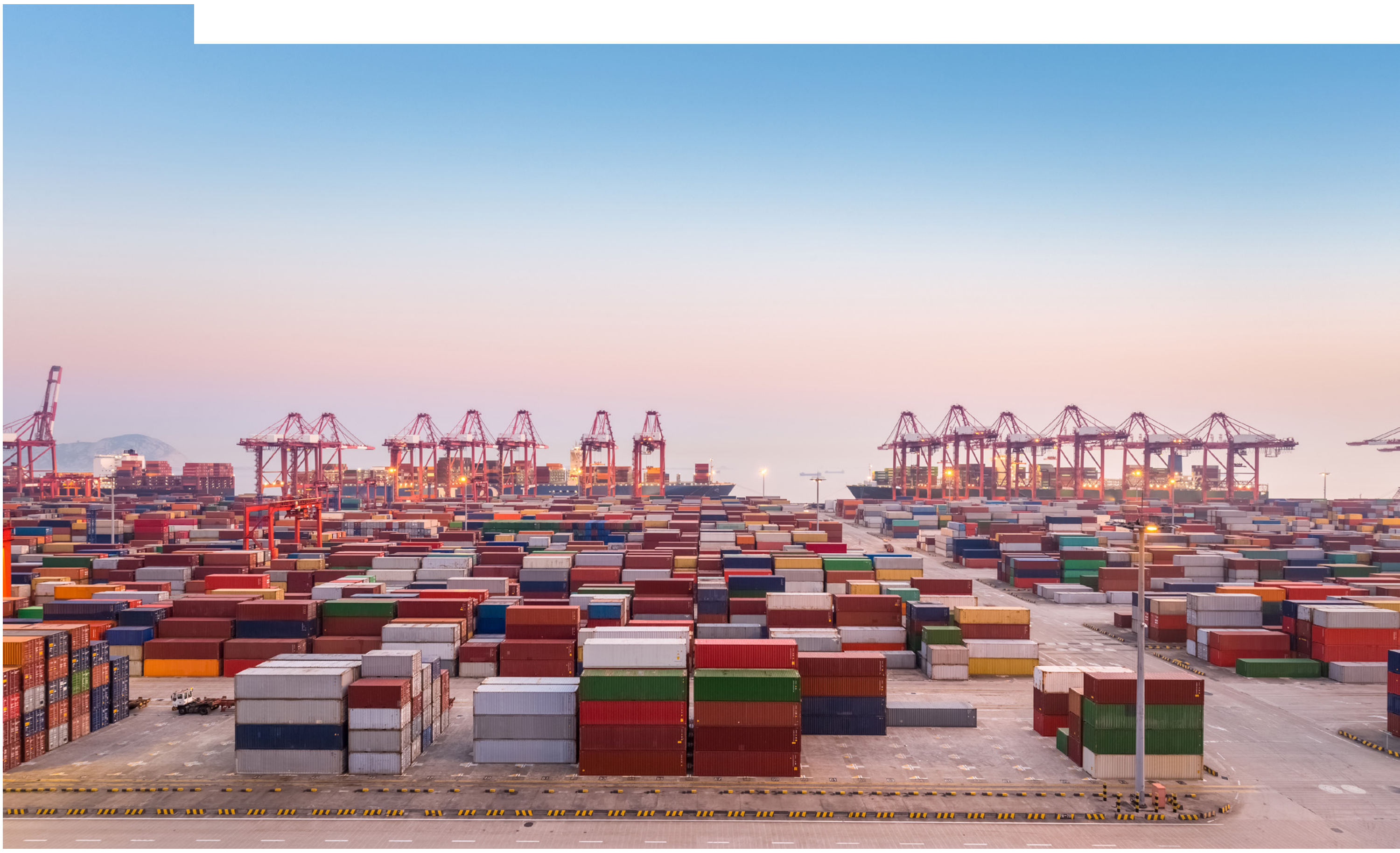
Measuring the impact of the ongoing cataclysm is difficult, but since China was the first hit, and seems to be the first to go back to normal, one can look there for data on the toll coronavirus measures have taken on SMEs. In February 2020, the Center for Global Development conducted a survey on the condition of micro, small and medium-sized enterprises (MSMEs) amidst the coronavirus outbreak in China. It found that 80% of small companies hadn't yet resumed operations, and 40% had no timeframe in mind for resumption. Sadly, 20% of surveyed firms said they wouldn't last beyond a month on a cashflow basis, and 64% not beyond three months. Considering the lockdown lasted almost three months in Hubei, the province worst-affected by the virus, many SMEs are expected to have been forced into bankruptcy. In fact, at the end of March, Chinese authorities estimated that only 60% of SMEs had reopened their doors.

In the West, governments are approving a range of measures to support businesses through the crisis with at the end of March, the European Commission authorised an Italian State guarantee supporting a debt moratorium from banks to SMEs affected by the coronavirus outbreak. This includes the postponement of repayments of overdraft facilities, bank advances, bullet loans, mortgages and leasing operations, with the goal of easing the financial burden on SMEs and making it possible for them to maintain existing jobs. The Italian measure is in line with the European Union's Temporary Framework, which allows individual member states to offer five types of aid to their companies: direct grants; selective tax advantages and advance payments; state guarantees for loans taken by companies from banks; subsidised public loans to companies; safeguards for banks that channel state aid to the real economy; and short-term export credit insurance. Outside of the EU, the US is offering similar support mechanisms to SMEs, including rate cuts, state loans or credit guarantees, income subsidies for affected workers, tax deferrals and social security deferrals or subsidies.

Trade finance must step in

But government support can only go so far. Even with state guarantees, banks are still haunted by the level of unsustainable loans that led to the 2008 financial crisis. Additionally, emergency measures tend to be focused on specific types of companies, omitting the complex and ever-connected supply chains they form a part of. This is why SME support should be focused on trade finance: not only does it support entire supply chains, but its short-term tenors also allow for a certain programme amount to be deployed several times a year, where it is needed most. The impact of the funding can be monitored daily, allowing for the efficient allocation of funds with this type of financial mechanisms requires no additional collateral from companies.

While trade finance could be one of the most efficient tools to keep SMEs afloat during this or any other crisis, one cannot deny the burden these assets continue to place on banks' balance sheets. To relieve this burden, banks must consider distributing trade finance assets through appropriate technological channels.



II.
Maturing fintech

Banks have learned that the key to serving the needs of SMEs is technology. When fintech became a recognised term, the number of companies being launched was hard to keep track of, and experts anticipated a lot of trial and error to take place, both technologically and in terms of business models. Now, the fintech industry is showing signs of consolidation. In its 2019 report The State of Fintech, Toptal points to a general trend in the fintech industry toward maturity: "Larger funds (getting closer in both size and behaviour to their private equity counterparts) investing in later stages of a company's life (…). This, coupled with the retreat in funding for seed-stage companies, points toward a general consolidation and development of the sector." According to the analysis, three factors are contributing to this: the maturing of the technologies that helped fuel fintech innovation (such as AI and machine learning); the deterioration of the macroeconomic situation in fintech hubs such as the UK and Europe; and the fact that the funds that tried to capitalise on uncertainty caused by the 2008 financial crisis are reaching the end of their lives, and are, therefore, getting ready to return money to investors.

Tech-led trade finance

With the maturing of the fintech sector, tradetech is also consolidating, and financiers are becoming more and more comfortable with new tools. In 2018, over 60% of banks reported they were in the process of digitising their traditional trade finance solutions, focusing mainly on robotic process automation and machine learning, according to the International Chamber of Commerce's Global Trade Survey.

Most global banks are involved in one way or another in the development of blockchain technology for trade — think R3, Marco Polo and We.Trade. While promising, these initiatives have yet to show concrete results beyond pilots and soft launches.

On the other hand, never before has the necessity of paperless, automated trade been so obvious, with social distancing measures preventing physical meetings and wet-ink signatures. This crisis could be the catalyst to turn years of investment into paperless trade and smart contracts into an everyday reality.

At the same time, artificial intelligence and machine learning are truly changing the trade finance game, and pushing traditional credit scoring methods out the door. It is possible to accommodate varying data availability across the depth of datasets. It also allows financiers to consider new and valuable information that could change the credit-worthiness of SMEs, such as geographic location or industry. And finally, artificial intelligence can automatically update these datasets from a variety of sources, making credit ratings more timely and accurate.

Technology and machine learning are also enabling the distribution of trade finance assets. On top of allowing banks and investors to efficiently and electronically connect, interact, and transact remotely on its platform, UK fintech Tradeteq uses an approach to credit analytics that leverages artificial intelligence to automatically update datasets with information from a number of sources, and applies a rigorous evidence-based credit scoring process. This allows investors to gauge the risk of the trade finance assets they purchase quickly and accurately, streamlining transactions on the platform.

III. Trade finance distribution becomes a reality

Macroeconomic and regulatory factors are pushing banks to distribute the risk on their balance sheets, while the urgent necessity to support SME trade is encouraging them to look for new sources of liquidity. Technology is enabling the streamlined distribution of trade finance assets to institutional investors and allowing all parties to make accurate credit decisions.

In February, ING partnered with Tradeteq to distribute commodity trade finance exposures to non-bank institutional investor Federated Hermes, a leading global investment manager with US$575.9bn in assets under management as of December 31, 2019. ING leads several other bank and non-bank institutions, which have joined Tradeteq's platform and are set to begin trading in the coming months.

Upon conducting the deal, Anthony Van Vliet, global head of trade and commodity finance at ING, commented: "This transaction shows how Tradeteq's electronic platform facilitates the distribution of an asset class with short duration in an efficient manner, something not possible until now. The distribution of trade finance assets is a natural evolution of the trade finance market and Tradeteq's technology is instrumental in helping us achieve this."

Additionally, 2019 saw the launch of the Trade Finance Distribution Initiative, an industry-wide effort to use technology and standardise the market to support the wider distribution of trade finance assets. The initiative, which aims to create a secondary trade finance marketplace with greater non-bank participation, gained significant momentum since its launch, with the number of members doubling from 14 to more than 30 in January 2020. In March, the TFD Initiative formed a formal association with the International Trade and Forfaiting Association (ITFA), which will give all ITFA members full access to the TFD Initiative's workstreams and enable them to participate in live projects and proof of concepts. This partnership is expected to give a further boost to the Initiative's efforts to standardise trade finance asset distribution.

Conclusion

The unprecedented crisis created by the Covid-19 pandemic is forcing trade finance distribution to move from a ‘nice to have’ to a ‘must have’. SMEs are in dire need of financing, and trade finance provided by banks and syndicated electronically to non-bank investors is the best tool to help them. Real-life use cases are expected to increase in the coming months, and standardisation efforts are consolidating, setting 2020 up to be a decisive year for trade finance asset distribution. This, in turn, will alleviate the capital burden placed on banks by Basel III and IV, and open the trade finance market to more liquidity from non-bank investors. With the help of maturing artificial intelligence technology, trade finance distribution has the potential to assist financial institutions in better serving the needs of SMEs, now and far beyond the current crisis.

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