TECHNOLOGY FOR TRANSPARENCY

Filling the Trade Finance Distribution Gap

TRADETEQ WHITE PAPER
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ITFA
International Trade and Forfaiting Association

GTR VENTURES

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Introduction

"Fear is rapidly dissipating from the bank-fintech model and a potentially beautiful relationship is in the offing as banks are increasingly seeking new investors as partners in the trade space, particularly on the funded side. This is a critical area of interest for the ITFA membership and our new ITFA FinTech committee is helping our membership navigate through those new technology propositions."

Sean Edwards, Chair of the International Trade & Forfaiting Association (ITFA)

The low risk profile of trade finance assets is a reality that has forever been preached from within the sector, yet interest from the general investment community only started recently as a side-effect of the low-yield environment. For one, banks are suddenly having to adapt to the stringent capital requirements put in place to protect consumers in case of another financial crash. This has prompted them to look for syndication, or the distribution of assets to other lenders, in order to share risk and free up their balance sheets. On the other hand, the investment community, having been burned by incredibly high default rates during the crisis, yearned for low-risk assets to diversify their portfolios.

One way that banks are sharing their trade finance risk is through synthetic securitisations: large-scale transactions started making headlines in 2013 but since then, only a handful of these deals have been signed. This is puzzling for market observers, who believe the supply of and demand for low-risk trade finance assets, should have made this, and other risk-sharing practices, commonplace by now.

In this white paper, we look at two elements that have been blocking the widespread distribution of trade finance as an asset class: one is the lack of reliable technological infrastructure to allow institutional investors to access trade finance portfolios, and the other is the need for standardised reporting to improve credit transparency. Filling these two gaps will push trade finance distribution from isolated one-off practices to an efficient, diverse and competitive marketplace.

What is Trade Finance?

Trade finance is a segment of the financial sector that supports importers and exporters as they conduct their trade activities. Traditional instruments include letters of credit, factoring, export credit and insurance, and represent a safety net to protect corporates from the counterparty, liquidity and currency risks involved in cross-border trade.

Risk-Sharing Gains Momentum

Whereas in the past, trade finance assets were kept on banks' balance sheets, new capital requirements have encouraged financial institutions to keep their balance sheets as light as possible. As a result, since the implementation of Basel III regulations, banks have been drawn to the so-called "originate-and-distribute" model, whereby they offer an import or export loan to a corporate as primary lender, and then turn to other institutions to share the risk burden.

New capital requirements have encouraged financial institutions to keep their balance sheets as light as possible.

This process, called syndication, involves the purchase of parts of a loan or portfolio by the secondary market, taking the original loans off the primary lender's balance sheet. It contributes to making Basel III leverage ratio calculations more favourable, but also creates new income avenues for banks, as they can charge secondary lenders a fee for originating the transaction.

"The supply of and demand for low-risk trade finance assets should have made distribution commonplace by now."

Kelvin Tan, Co-Founder & Chief Investment Officer of GTR Ventures

Over the years, banks have broadened the range of trade finance transactions they looked to syndicate: while in the past, they focused mostly on distributing risk in bank-to-bank instruments such as letters of credit and promissory notes, they now syndicate transactions signed directly with corporates, such as receivables financing, supply chain finance and trade loans.

Another consequence of enhanced and burdensome know-your-customer (KYC) and anti-money laundering (AML) requirements has been a drop in banks' risk appetite, particularly for small and medium enterprises (SMEs). This created a gap that has partly been filled by technology-led invoice finance providers, who offer a marketplace for corporates to sell their invoices to a pool of investors at a discounted price, cutting their payment times.

Trade Finance:
A Safe Addition to Investment Portfolios

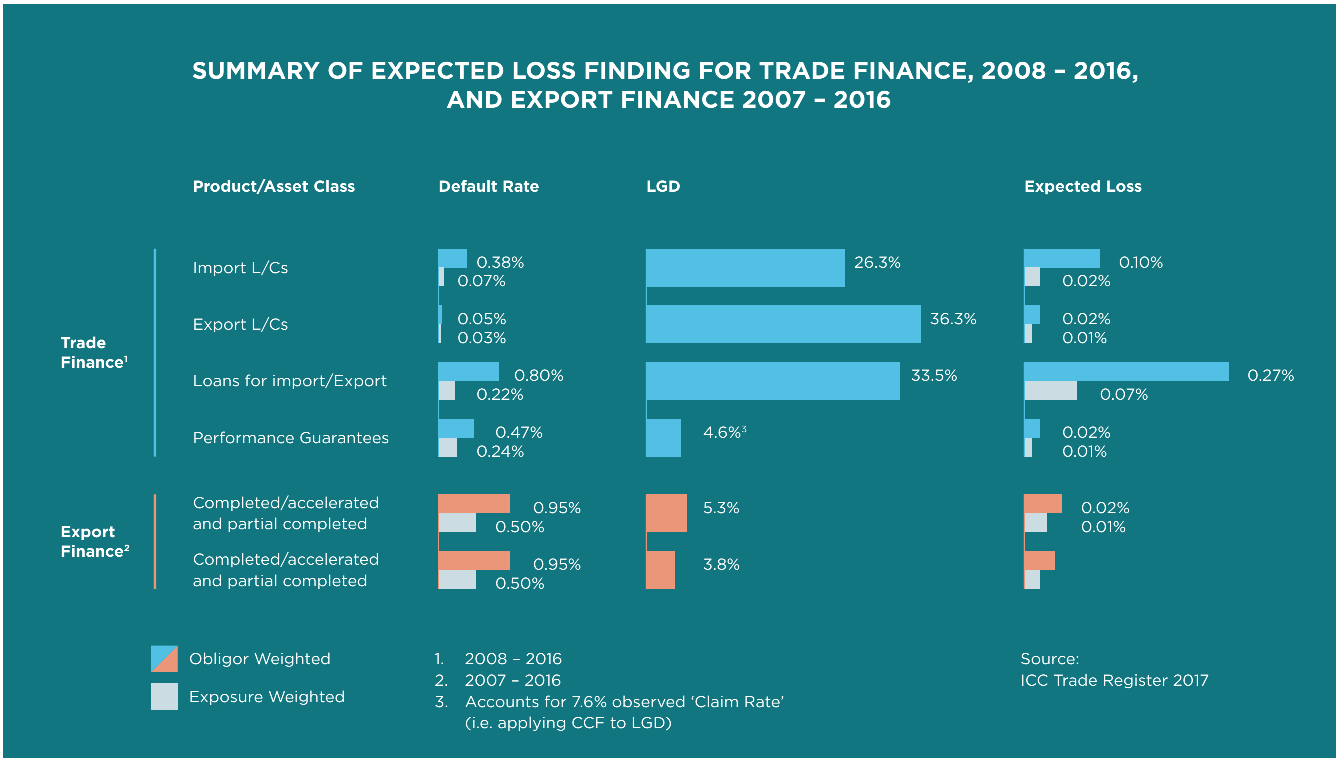
Meanwhile, institutional investors have grown more and more interested in trade finance assets. In the current low-yield environment, they are placing more emphasis on safety, prioritising diversification and stable returns. Because trade finance is based on tangible trade flows, it has a low correlation to stocks or bonds, making it a safe addition to any investor's portfolio.

> *"Trade finance is a reliable and low risk asset class and should be looked upon favourably by regulators, industry stakeholders and institutional investors."*
>
> *Daniel Schmand,*
> *Chair of the ICC Banking Commission*

Trade finance's attractiveness as an asset class is recognised and supported by data. In 2017, the International Chamber of Commerce (ICC) Banking Commission published a report on the risk profile of trade finance assets, analysing information provided by 22 member banks. The data set included US$10.5tn of exposures and more than 20 million trade finance transactions from 2008 to 2016 - approximately 40% of global trade finance flows in that period.

The 2017 Trade Register found that default rates for trade finance products from 2008 to 2016 are ranged between 0.05% and 0.24% depending on the type of product and region - lower than most other asset classes. Additionally, time to recovery in case of default is much shorter for trade finance (61 to 184 days) than for other products (at least 400 days).

"The 2017 Trade Register reiterates what we have seen year on year since the project was initiated in 2009: that trade finance is a reliable and low risk asset class and should be looked upon favourably by regulators, industry stakeholders and institutional investors," said Daniel Schmand, Chair of the ICC Banking Commission.



"FinTech companies are introducing new collaborative technology platforms for banks and their investors to re-invent their relationships and grow their business. As adoption grows, banks will succeed to establish trade as a more investible asset class, thereby bringing more financing capacity to their own clients. This is the very focus of the ITFA Fintech Committee."

André Casterman,
Chair of ITFA FinTech Committee

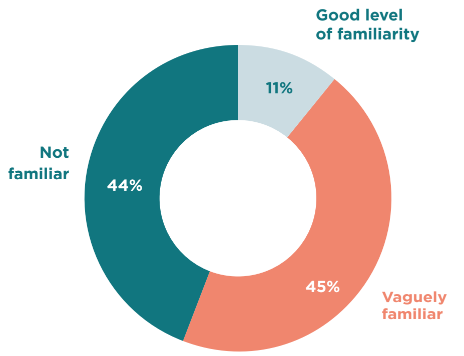
Infrastructure and Transparency Concerns

Considering the above, it is surprising that the distribution of trade finance assets from originators to institutional investors hasn't become more recurrent than it is today. Part of the problem is language-related: trade financiers must learn to discuss their business in the language of investors, as many of them are unfamiliar with specific trade finance terminology. In 2016, the ICC, along with other industry associations, developed a list of definitions for techniques of supply chain finance in an attempt to standardise the industry's vocabulary. But two years later, the document is still far from being universally implemented.

Investors have to deal with a multitude of reporting styles from different originators, preventing the aggregation of their portfolio.

But more importantly, it is the lack of efficient channels to conduct this type of business that is blocking progress: neither banks nor investors have the right technological infrastructure to connect supply and demand. While banks have made recent efforts to digitise trade transactions, these have been mainly focused on improving the user experience for their corporate clients, with electronic documentation or smart contracts for example. In contrast, little thought has gone to improving infrastructure around the syndication side of the transaction.

FAMILIARITY WITH THE CONCEPT OF SECURED AND UNSECURED TRADE FINANCE

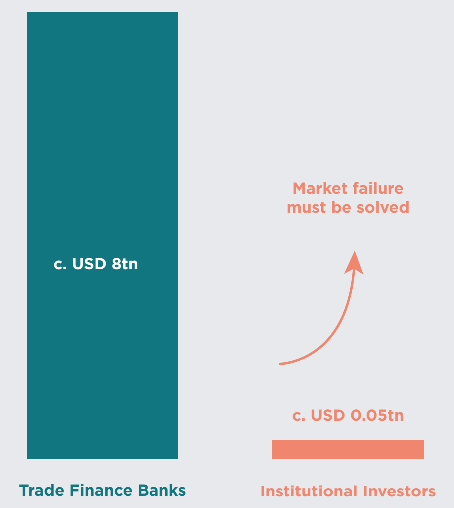


Note:
Based on 56 responses

Source:
Greenwich Associates 2017 Trade Finance Study

Non-bank originators such as invoice discounters have developed efficient customer-facing platforms, but because of the networking effort that is required to bring small corporates to the marketplace, they generally struggle to expand their reach beyond their own region and to attract a diversified pool of external capital.

USD 8TN OF BANK-INTERMEDIATED TRADE FINANCE ASSETS VS USD 0.05TN OF INSTITUTIONAL INVESTMENT IN THE ASSET CLASS.



Source: source: WTO; PwC

The other issue is the lack of standardisation in reporting requirements: pension funds, asset managers or family offices all ask for different risk metrics, from solvency capital consumption to payment history, which means portfolio presentations have to be made on a case-by-case basis. On the other hand, investors will rarely allocate all their investments to one originator or obligor, which means they have to deal with a multitude of reporting styles from different originators, preventing the aggregation of their portfolio.

In a 2017 survey of 56 decision-makers at European investment institutions including corporate, public and collective pension funds, banks, insurance companies, endowments and churches, conducted by Greenwich Associates on behalf of EFA Group, credit and environmental regulatory constraints were cited as one of the main obstacles to investment in trade finance assets. To overcome this limitation, transparency is key - yet it is currently lacking. Without an efficient platform providing visibility on the nature and credit risk of transactions, institutional investors will remain reluctant to get involved in this space.

Technology and Artificial Intelligence to Bridge the Gap

Technological progress and the advances in artificial intelligence (AI) in recent years have shaped the contours of what will likely become the foremost solution to the issues of language, infrastructure and transparency that are blocking the growth of trade finance asset distribution.

Imagine a global network where trade finance financiers, bank and non-bank originators, investment managers and corporates could connect and transact. AI can be used to deliver advanced credit analytics and reporting, making trade finance asset investment both transparent and scalable.

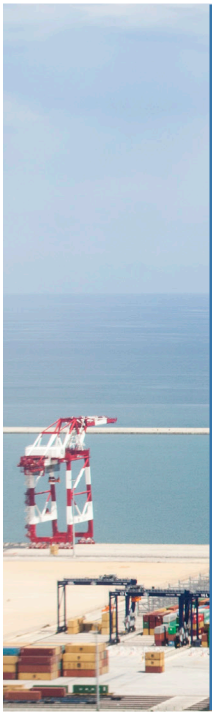
AI can be used to deliver advanced credit analytics and reporting, making trade finance asset investment both transparent and scalable.

Investors can use this technology to make sound credit, diversification and pooling decisions, with a rules-based workflow that ensures eligibility criteria and portfolio guidelines are met.

Originators should be able to list opportunities, share data and negotiate the transaction structure and terms, with improved credit risk transparency. Banks need appropriate infrastructure to run a profitable originate-and-distribute business model. Non-bank originators such as invoice discounters would benefit from an easy and standardised procedure to upload and advertise their portfolio opportunities with institutional investors, and the right platform should provide the common language needed for greater understanding.

Data is key for transparency, and having a common platform would ensure its accurate collection. The aggregated information can then be used to create credit analytics and risk profiles, making trade finance data not only transparent, but actionable. This way, investors can avoid the negative selection of trade finance opportunities by originators.

By being cloud-based, such a platform can also give investors unprecedented access to trade finance assets, whatever the device or location.



Conclusion

Trade finance is an attractive asset class for investors as it promises higher than risk-commensurate returns. However, the market is fragmented, inefficient, illiquid and generally hard to access. Technology and artificial intelligence should be leveraged to make trade finance accessible and reduce the operational burden and costs for both originators and investors.

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