Summary
- Institutional investors are being asked to fill the gap left by banks, which have stepped back due to Basel III and stricter capital requirements.
- The benefits are low correlations, diversification and a hedge against rising inflation.
- Trade finance can cover a wide spectrum of lending structures that support the production, transportation, and payment terms of global trade.

Filling the gap

Lynn Strongin Dodds investigates the opportunities trade finance presents as an asset class for pension schemes and other institutional investors

While trade finance is among the oldest forms of institutionalised credit, it has only been in the past few years that the sector has become an asset class. Banks have left a gap and institutional investors are slowly stepping in as they search for stable risk-adjusted returns and downside protection.

It has not had an easy time though. The problems in trade finance over the past decade have been well documented. The pandemic, supply chain issues and sanctions against Russia have only exacerbated the situation although, over the past year, the picture has improved.

Figures from Coalition Greenwich show that in the first half of 2022, the world's 10 largest transaction banks posted a combined revenue of $15.6 billion from cash management and trade finance, a 22 per cent rise from $12.8 billion in the same period last year. Breaking it out, trade finance grew 7 per cent year-over-year according to Coalition Greenwich head of global banking research director, Eric Li.

Li said that second-quarter activity drove most of the growth, with revenues from both cash management and trade finance reaching their highest level since the global financial crisis.

The report noted that supply chain disruptions within sectors such as agricultural commodities and energy due to Russia's invasion of Ukraine have led to a greater corporate need for supply chain and commodity trade finance. Revenues from both products were up more than 20 per cent in the first half of 2022.

Although it is difficult to predict the future given the current bout of market volatility, there are opportunities in the small to medium enterprises (SME) arena. Research from the Asian Development Bank revealed that SMEs are disproportionately affected by the $1.7 trillion trade finance gap – the difference between the number of applications to finance companies' participation in international operations and the number of approvals. They account for 40 per cent of such rejections, which is much higher than their share of applications.

Separately, a report from the World Bank noted that SMEs are underserved and lack access to affordable trade finance, despite accounting for around 90 per cent of companies and more than half of the jobs worldwide.

A higher level of working capital is also impacting the market in general, according to Allianz Global Investors portfolio manager, Mike McGill. He adds that higher inflation has increased input costs as well as the capital needed to

purchase and carry inventories.

"It is a confluence of different things," says McGill, who works in the trade finance team. They range from the bottlenecks in global shipping and warehousing that are extending the cash conversion cycle for companies, to more volatile demand patterns and access to supply. As a result, companies increasingly carry more inventory to ensure continuity and growth of sales.

In the past, companies across the spectrum would have turned to banks for help, but they have stepped back due to Basel III and stricter capital requirements which will only become tougher under the impending IV version. Estimates show that there has been an increase in risk weights for lending in the trade finance of around 15 per cent since Basel III was implemented, while the proposed changes under Basel IV could effectively impose 100 per cent risk weights in areas such as agricultural commodity finance.

Market participants believe this is largely because the regulations do not properly recognise protective features in lending structures such as collateral, while over penalising revolving facilities and letters of credit. The fall in bank lending capacity comes at a time when demand for agricultural production, and specifically food production, is forecast to significantly rise over the coming decades to support growing populations and levels of prosperity.

As McGill notes, "banks had typically operated a buy-and-hold" strategy but many are now more interested in an originate-and-distribute model. "This has translated into asset managers acting as an intermediary and setting up fund structures."

Some organisations such as the International Trade and Forfaiting Association (ITFA) would like to see more done to encourage trade finance as an asset class for alternative investors such as asset managers, insurance companies and pension funds. The trade group argues that it has many attractions including appealing risk-adjusted returns, short duration and low volatility, as well as defensive and countercyclical behaviour compared with other asset classes.

Overall, trade finance encompasses a wide spectrum of different lending structures which support the production, transportation, and payment terms of global trade. Loans are typically short-term and self-liquidating, often secured, and offer a yield pickup over other liquid credits of similar ratings. They are often seen as an alternative to credit assets such as asset-backed securities and short-dated investment-grade bonds due to a potentially higher yield on the back of a complexity premium.

"Trade finance allows investors to be tied into the real economy and less dependent on market fluctuations"

"Trade finance has the potential to be attractive in today's environment," says Hymans Robertson senior investment research consultant, Penny Cochrane. "As assets roll off, capital is reinvested into new instruments – allowing for repricing of assets in today's volatile environment."

She notes the key attractive features of trade finance are that it provides an uplift to cash with short duration – 120 to 180 - and low volatility. "Due to the sometimes very short-term nature of these assets there is little interest rate duration," she adds. "And the private nature of the instruments, means the asset class has a smoothing effect on volatility. Given the short-dated nature of the asset class, default probability is less than that of longer-term ratings equivalent credit and it correlates to a lower expected loss."

Allianz Global Investors head of global high yield, David Newman, who manages global high yield and multi-asset credit strategies within the global fixed income team, also points to the diversification benefits and low default rates. He notes that its potentially low correlation to other asset classes can help investors manage a rising interest rate environment. "Investments in trade finance can help investors manage downside risks as it tends to exhibit low volatility," he adds.

Tradeteq CEO, Christoph Gugelmann, echoes these sentiments. He believes that it not only provides lower correlations with traditional asset classes but also has a better risk profile. "Trade finance allows investors to be tied into the real economy and less dependent on market fluctuations," he says. "Also, there is always a commercial angle. For example, when an airline cuts costs, the unsecured senior bond holder will be most affected. However, it will always need the kerosene to fly the plane."

As with any investment, "there are several challenges to be cognisant of when investing in trade finance," says Cochrane.

"Banks continue to be the dominant player in this market, and they occasionally partner with other platforms and asset managers, so investors need to be comfortable in that relationship," she adds.

Cochrane highlights the lack of dedicated trade finance funds in the market. However, this is changing: "Due to bank retrenchment seen across the private credit markets, investors are increasingly getting the opportunity to participate," she adds. "This has been accelerated by fintech-enabled platforms, particularly in supply-chain finance, which are likely to continue to take market share."

Written by Lynn Strongin Dodds, a freelance journalist

In association with