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Trade finance: an attractive asset class

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Investors are always looking for attractive investment options. Over $110 trillion of investible assets exist globally in insurance, pensions, endowments, sovereign wealth funds, hedge funds, foundations, mutual funds and private wealth management. And while acknowledgement of the advantages of trade finance – both traditional and supply chain finance – is growing among policymakers, political and academic circles, trade finance is still not the first thing to spring to mind when considering investments. We need to change that.

An attractive asset

So, what are the attractions of trade finance as an investment? Undoubtedly, trade finance is a compelling investment option, with high yields and low volatility. Year-on-year, since 2009, the International Chamber of Commerce (ICC) Banking Commission's Trade Register report has reinforced the low credit and default risk nature of trade finance.

The 2016 Trade Register, 'Global risks in trade finance', notes that short-term products are particularly low risk, citing the default rate (weighted by exposure) at 0.08 percent for import letters of credit (LCs), 0.04 percent for export LCs, 0.21 percent for import/export loans and 0.19 percent for performance guarantees. By way of comparison, against corporate loans, the 2015 Trade Register estimated that export LCs have a rough equivalence of between an Aaa and Aa Moody's rating.

According to the Trade Register, medium- and long-term products also prove low risk. This is driven, in part, by the fact that in-scope transactions are covered by OECD-backed export credit agencies (ECAs) at up to 95 percent of their value. The average default rate of medium- and long-term trade finance is 0.44 percent, with a loss given default of 5.3 percent – driving an expected loss of 0.024 percent.

Clearly, trade finance presents an interesting opportunity for investors who want to generate yield without taking on excessive rate and credit risk. For instance, the international fixed income team at Federated Investors, Inc – an asset management firm headquartered in the US – found that trade finance assets could provide a significant source of alpha for their international bonds and strategies. Trade finance instruments offered a short-term floating rate asset with limited exposure to rate duration or credit duration, while generating competitive yield.

Finally, it is worth noting that in addition to being a potentially valuable investment, trade finance is also an important one. Trade finance oils the wheels of global trade, which in turn drives economic growth. With the global trade finance shortage currently estimated at $1.6 trillion by the Asian Development Bank, banks and trade finance providers cannot address the unmet demand alone. Institutional investors can play their part in diversifying funding and helping to fill the trade finance gap, thus securing and strengthening their wider operating environment and the global economy in the process.

Room for improvement

Given this, why are more investors not queuing up to take advantage of the opportunities offered by trade finance? In part, this is due to the industry itself. Certain barriers need to be overcome to make trade finance easier to navigate for investors. And according to the Trade Register, project and trade finance remain essentially invisible to investors. Indeed, the structure, mechanics and difficulty of accessing a consistent flow of deals makes investing in project and trade finance challenging.

Furthermore, trade finance has traditionally been targeted to other banks as an investment, whereas financial investors are in a separate sales force. Those who operate in financial sales are often protective of client relationships, and limited knowledge of trade finance means that attempts to cross-sell have had limited success. Clearly, engaging such a sales force will require educating the client base in order to raise the demand for trade assets.

Trade finance deals have also previously faced a number of challenges, including the fact that few custodians are able to settle or safe-keep the deals. There are few back office operations equipped to deal with the documents and accounting requirements demanded of trade finance, and the major originators of deals are often unaccustomed to dealing with a financial investor. Another serious impediment is the fact that there is no information on Bloomberg terminals – the first point of call for most investors. In addition, it can be difficult to access the consistent volume of the flow of deals needed to maintain an aggressively diversified portfolio. Finally, we have the duty of adhering to anti-money laundering (AML) and know-you-customer (KYC) requirements – which even larger banks find challenging. Indeed, 62 percent of respondents to the ICC Banking Commission's 2016 global survey suggested they had declined trade finance transactions due to AML or KYC issues. Furthermore, bank compliance is geared to other banks, not to financial investors, making it even more of a barrier.

Engaging investors

Fortunately, there are steps we can take to make the trade finance industry more hospitable to institutional investors. Firstly, advocacy from the trade finance industry is needed to continue to raise awareness among investors, as there is room to further educate senior bank executives around the value and importance of trade finance. Industry stakeholders should therefore articulate and promote the value of trade finance. Partnerships with the World Trade Organisation, multilateral development banks, the UN system and other organisations must be nurtured and developed as part of this process, and can be complemented with dialogue, awareness-raising and engagement with the investor community.

In addition, there is a crucial need to provide clarity and fluidity into the trade finance industry, and to ensure there is ongoing engagement to present trade finance as an attractive asset class to investment managers. But trade financiers must also discuss the business of trade finance in the language of investment banking, given that many investors are likely to be unfamiliar with specific trade finance terminology. In fact, very few institutional investors are familiar with the mechanics or terms associated with trade finance. Certainly, consistent language will provide fair and appropriate comparisons with other investment options under consideration.

In turn, investment managers need to be open to discussion about alternative investment options, and to actively engaging with trade financiers. The Trade Register, for instance, can facilitate informed, constructive dialogue between the investor community, the trade finance community and regulatory authorities.

While the Trade Register can provide investors with a view of the credit-related characteristics and quality of the business and investible assets brought to the market, there are other tools that can also be employed. For example, informative groups, web resources notifying investors of upcoming deals and conferences on trade finance as a financial asset class – particularly aimed at institutional investors – would go a long way toward making the investment case for trade finance.

In addition, reflecting trade finance on platforms such as the Bloomberg terminals would be a sure-fire way of raising the awareness of trade finance instruments among the potential investor base – and a quick one. Investors need to be actively introduced to the concept of investing in trade finance, and supported with the tools and infrastructure they need to research, manage and execute deals.

Room for investors

Clearly, the benefits of increased uptake from institutional investors to the trade finance industry, and investors themselves, are compelling – as is the opportunity to drive economic growth from new partnerships between trade financiers and investment managers. There is also room for investors to engage, but first we must actively introduce them to the concept of investing in trade finance. Trade finance may not be the obvious investment, but it certainly holds value. And whether or not increased investment would benefit a crucial, yet underserved industry is without question.

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