Trade finance: emerging asset class

Heavy investment in the natural resources sector from early 2000s is a major catalyst for the revival of this industry

By **CHRISTIAN STAUFFER**

WHILE trade finance represents an essential cog in the wheel of the global economy, it has only recently been popularised in the mainstream media.

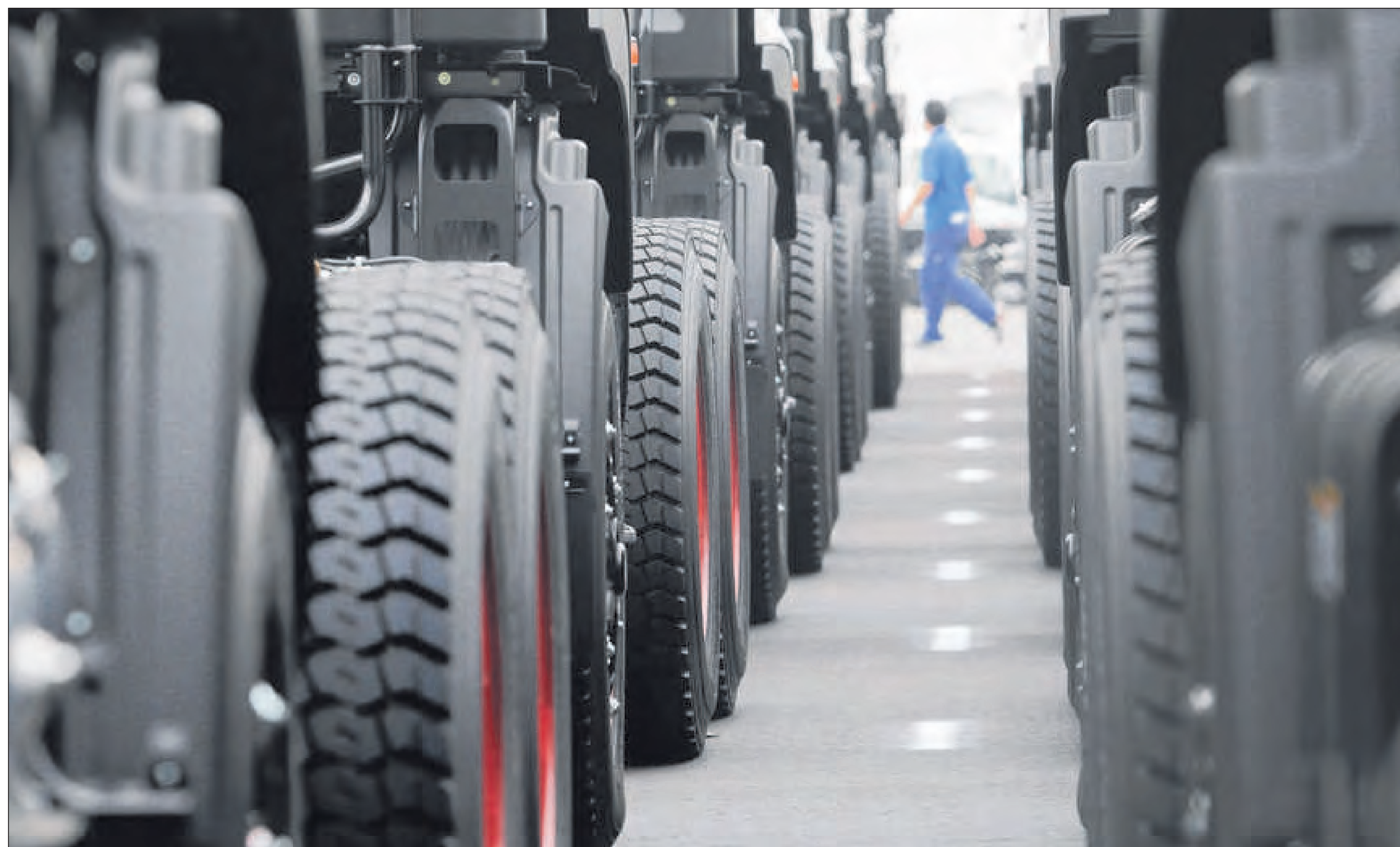
With the mounting pressure on bank balance sheets stifling the ability of banks to finance physical trade flows, and an understanding of the importance of these trade flows to the smooth functioning of global economic activity, trade finance has shot into the limelight as a topic of significance impacting us all.

Let's take a step back and try to figure out why. Most businesses that produce, manufacture, transport, or transform physical goods share the need for short-term senior working capital loans.

From a national power utility purchasing energy products, to metal stockists distributing construction material to the real estate industry, to the suppliers of grains to feed-millers, everyone, at every step, utilises trade finance as their bloodline.

In global trade, companies need to pay for goods before they can move or transform them and resell them at a higher value. Without trade finance, companies will be limited to working exclusively with their own equity, allowing them to do less business and resulting in less goods being traded, a situation unimaginable in today's high-consumption growth driven world.

Trade finance is characterised by a bilateral, secured senior loan between a trade finance provider and a borrower. The underlying goods being financed, which have already been purchased and pre-sold at a given price, collateralise these loans. Each transaction is thus backed by an identifiable and verifiable trade flow.



Ready to roll: *The appearance of non-banking capital providers has for the first time enabled non-specialised investors to directly access trade finance as a class of asset.* PHOTO: AP

When trade finance liquidity dries up, there is an immediate effect on businesses deprived of much needed working capital, unable to fulfil their obligations, and unable to provide the goods we as the general public need and take for granted to go about our daily business.

Until the late-1990s, trade finance remained a banking business with a high barrier to entry. This status quo created a handicap for borrowers: a limited ability to diversify their sources of financing due to a negligible pool of non-banking capital providers.

However, the historic level of investment in the natural resources industry beginning in the early 2000s proved to be the major catalyst for the revival of the trade finance industry.

The period between 2001-2011 saw the price of most commodities and their associated transportations costs increase five-fold or more. At the same time there were sizeable increases of the volumes transacted. Industry participants had huge new capital requirements to fill this gap.

Simultaneously, the international banks continued a period of mergers and consolidation resulting in a trade finance market dominated by fewer than 10 banks holding an 80 per cent market share, with each bank consolidation reducing the aggregate liquidity in the market.The contraction phenomenon became even more obvious with successive Basel agreements putting banks' balance sheets in the spotlight.

New capital requirements have caused banks to reduce their exposure to trade finance as a means of shoring up capital to strengthen their balance sheets. Trade finance portfolios thereby became innocent casualties, sacrificed to generate quick capital to comply with newly imposed balance sheet ratios.

In a nutshell, US dollar credit availability has diminished in a market that requires more and more credit to fuel growth and compensate for the explosion in commodity prices. This has left some space for alternative non-banking providers to move in. While banks are, and will remain, the main provider of short-term senior debt in the trade finance industry, their retraction has left an interesting and niche to be filled by non-banking financiers.

The appearance of non-banking capital providers has for the first time enabled non-specialised investors to directly access trade finance as a class of asset.

Be it through a fund, a note, or other type of dedicated vehicle, managers have been able to package trade finance assets of various types and offer them in the form of a dedicated investment strategy.

What are the advantages of trade finance as a class of asset?

◆ **Non-correlation:** It is the non-correlation to other asset classes that is the most defining feature of trade finance. Trade flows may vary in terms of size (a combination of the volume and the price of underlying goods) but there is no risk of a total interruption. The action of financing these flows, therefore, allows returns to be produced even during periods of economic downturn.

Further, the structured nature of trade finance transactions aims to disconnect the asset from the corporate balance sheet thereby ring fencing the insolvency risk of the borrower in case of serious and prolonged economic downturn.

Lastly, the self-liquidating nature of a trade finance transaction will isolate the asset from the volatility of its underlying trade product. The commodity price volatility is neutralised by binding Sale & Purchase contracts between all counterparties.

◆ **Low volatility – low default & high recovery:** Extensive data demonstrates the very low rate of default of trade finance transactions when properly implemented. Of 5,223,357 transactions recorded by the International Chamber of Commerce among nine banks and over a four-year period between 2005-2009, only 1,140 transactions defaulted. A default rate of 0.02 per cent.

This low risk of default is combined with an extremely low volatility on the basis of a properly constructed portfolio. Moreover, the very low event of default is accompanied by a high probability of recovery (around 60 per cent in the ICC data study). The financing structure aims at keeping the legal ownership of the underlying product segregated and assigned to the Financier, therefore maximising the opportunity for recovery in case of default.

◆ **Identifiable cash flows through interest revenue:** A further feature of the trade finance class of asset is a natural, identifiable cash flow resulting in net asset value appreciation. Since a trade finance loan generates a payment of interest for the tenor of its utilisation, this interest revenue has an immediate and positive impact on the net asset value.

Trade finance assets follow a loan and receivables accounting method. This method is generally easier to apply and understand than complex fair value accounting models used in listed security investment strategies. Moreover, it is easy to detect any impairment in the trade finance strategy as it will result in one or more of the assets not performing and therefore not producing revenues. Lastly, in terms of due diligence and assessment of the implementation, each and every loan is granted to a verifiable real economy company for the use in a particular identifiable transaction flow.

In conclusion, trade finance is a class of asset that produces a low risk, low volatility, non-directional return with identifiable cash flows derived from easily verifiable companies and trade flows. It is structured to limit downside risk while producing uncorrelated returns over base rates.

The world has moved away from a period of excess liquidity, with structural economic indicators converging on a period of less available and more expensive capital. Combined with a continuous increase in the cost of goods, the market will require new sources of capital to substitute, at least partially, the capital withdrawn from the banking sector.

The effect of non-banking trade financiers in the market is two-fold: on the one hand their capital is increasingly crucial to global commodity trade; on the other, their participation represents a unique investment offering, providing a vehicle to an asset class that generates a non-directional yield and demonstrates characteristics that will be appreciated by those who value capital preservation and non-correlation while maintaining reasonable liquidity.

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Britain will do well not to quit EU

By **HUGO DIXON**

LEAVING the European Union would be bad for Britain. Membership of even an unreformed EU is better than "Brexit". Quitting would mean either not having access to the single market – at a huge cost to the economy – or second-tier membership. The debate over Brexit has moved into high gear in the past 10 days, after the UK Independence Party – which wants Britain to pull out of the EU – performed well in English local elections. The Conservative party, which rules in coalition with the pro-European Liberal Democrats, has been thrown into turmoil because UKIP has been winning votes largely from the Tories.

What's more, many Conservatives would like Britain to quit the EU too. Last week Nigel Lawson, one of Margaret Thatcher's finance ministers, argued the case for Brexit. Boris Johnson, the mayor of London who is the Conservatives' most popular politician, also shuffled a little further in a eurosceptic direction – although he stopped short of calling for an exit.

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David Cameron himself has not shifted his position. He wants to hold a referendum in 2017 after he has had a chance to renegotiate Britain's relationship with the EU in so far unspecified ways. But he may be tempted to tacitly support legislation to call a plebiscite in an attempt to embarrass the opposition Labour party which has so far refused to back such a vote.

Despite the increasingly anti-European tone of the debate, the overall likelihood of Britain quitting the EU hasn't really changed since the local elections. True, the probability of the British people voting in favour of staying in the EU in a referendum has fallen. But the chance of such a plebiscite taking place has also probably dropped – because UKIP's rise makes it less likely that Mr Cameron will be reelected in 2015.

It is, of course, possible that the pro-European Labour party will match Mr Cameron's promise to hold a referendum. But that would probably be against its interests. A future Labour government would find it hard to win a referendum – as the Conservative party, unconstrained by government, as well as its allies in the media would mount a vociferous anti-European campaign. After such a defeat, Labour would be left reeling.

If Labour felt the only way to win the next election was to promise a referendum now, it might still take the risk. But its chances of winning have risen in the past 10 days. And any attempt by the Tories to embarrass Labour for not backing a plebiscite is more likely to backfire by further exposing the divisions in its own ranks.

Pro-Europeans, though, can't just calculate the political probabilities. They need to make the case for staying in the EU.

Anti-Europeans often fudge the question of whether they would like Britain to quit the single market as well as the EU. They should be invited to clarify precisely what they mean.

Quitting the single market would be extremely bad for the economy, since about half of Britain's trade is with the EU. This wouldn't all vanish. But all sorts of barriers would make it much harder for companies to do business across frontiers, leading to a big rise in unemployment.

Britain has the world's third-largest stock of foreign direct investment after the United States and China. But multinational companies, which have used Britain as a hub in part because it has access to the single market, would curtail their investment if that was no longer so. The City of London, the UK's most successful industry, would also suffer if it was cut off from its European hinterland.

Not surprisingly, many eurosceptics don't want to quit the single market. They think they can have unfettered access to this market without the rules and regulations that irritate them.

The idea that Britain can have its cake and eat it is naïve. The rest of the EU might well allow it access to the single market – and even then not on an unfettered basis – but only if the UK abided by its rules. What's more, it wouldn't then have a vote on those rules, putting its business at a disadvantage.

That's the position Norway, which is not in the EU, finds itself in. It also has to pay almost as much on a per capita basis as Britain for the privilege of such second-class status.

The anti-Europeans are fond of lambasting Brussels bureaucracy. They also point to misguided policies such as the Common Fisheries Policy, which results in dead fish being thrown back into the sea, or the planned Tobin Tax, which will gum up financial markets.

These attacks are fair, even if they don't snuff out the case for staying in. But Britain has a golden opportunity to help reform the EU. This is because the main solution to the euro zone's crisis is to make it more competitive. It's a misconception to suppose that the euro zone is charging towards political, fiscal and banking union – as Germany is just not willing to pay for it.

Instead, the single market needs to be properly extended to services. Free trade needs to be promoted with other blocs such as America. And capital markets should be boosted as a solution to Europe's banking malaise.

Mr Cameron needs to start pushing this agenda now. Achieving it would not just be good for Britain. It would increase the chance of persuading the electorate to vote yes in any referendum.