

Le dernier mot

Jean-François Lambert asks whether trade finance funds complement or compete with banks. The answer could profoundly change the trade finance landscape and its dynamics



In the past five to 10 years, many names have established their credentials as trade finance funds and appear today as a new class of lenders, alongside banks, providing support for trade finance, mainly in commodity trade but also along large semi-finished products' supply chains.

The rationale for the emergence of these trade funds stemmed from both a need and a concern. The need was created by the banks themselves. In the wake of the financial crisis, the call of society at large for safer banks was answered by a call for stronger capital requirements and more rigorous regulations. Banks had to seriously shrink their balance sheets by decreasing their risk weighed assets. Large exits followed and affected mostly, but not solely, SME financing¹. The concern was on the investors' side where quantitative easing measures taken by central bankers to foster stubbornly stagnant economies, resulted in zero or negative interest rates. The return on large pools of liquidity thus became unattractive. The credit gap had to be filled and investors were on the lookout. Trade finance, a self-liquidating business following tangible flows of goods, with compelling low risk statistics gathered by the ICC² proved an attractive solution.

Despite interest displayed by investors in trade finance, the allocation of funds has remained rather small. My not-so-conservative estimate is a maximum US\$20bn of trade assets under management in the context of a bank-intermediated market estimated at US\$6.5-8trn. While it is early days, investors' knowledge of trade finance dynamics remains low and it would be a huge leap of faith for them to comfortably consider this asset class as an alternative to cash. 'Alternative' is indeed the important adjective. The catch is that it has a different meaning whether you are an investor or a borrower.

For an investor, 'alternative' is coupled with 'investment'. In this context, it is construed as a non-conventional high yield asset which is kept as a rather marginal niche investment as opposed to more liquid asset classes such as cash or bonds. The borrower, meanwhile, is keen to identify alternative funding sources, commensurate with their business dynamics (type, size and tenor), and attempt to limit chronic over-dependency on a potentially less reliable banking industry. The SME market that banks left on the table offered a perfect match: a genuine gap to fill, offering high returns (typically 650bp and beyond) on small credit facilities, (ie a diversified risk portfolio). Several savvy trade funds therefore hired teams of ex-bankers and thrived on this market replacing banks without really competing with them.

Until today, most if not all trade finance funds are still focused on the small and middle corporate business. Can they go beyond that and eat-up a bigger slice of the bankers' trade finance market? I doubt it for several reasons:

- Until investors reconsider their 'alternative investment' approach for trade finance, the focus on SMEs will prevail. Although there are still untapped pockets of high risk, high return business in many parts of the world, little is bankable beyond the reach and appetite of local banks. Besides, investors' interest will naturally be limited to the less challenging jurisdictions where there is no reputational risk.
- Trade funds credit risk management is very similar to banks'. To maintain profitability, trade funds need to focus on highest returns with wide diversification. The more diversified the risks, the more resources are needed to manage relationships and transactions whatever their number and size. This model is not easily scalable.
- While there is a general misperception

around regulatory requirements – managing other people's money is indeed tightly regulated – trade funds don't fall under the Basel guidelines in the same way as banks. This is no small competitive advantage when it comes to pricing a facility. Trade funds do not currently create any systemic risk. A broader ambition would however attract the Basel regulators' attention with potentially negative consequences.

- Banks are not ready to vacate the space. Banks may have sharpened their focus on optimising return on capital and have raised compliance requirements but few have completely shut down their trade finance business. The challenge for them³, is of a different nature: trade finance will change, not disappear.

Trade finance funds are therefore likely to remain in a niche, alongside the banks. However, diversifying sources of funding is a long-term goal of the commodity industry, and with the will the way will eventually come. Attracting the large pool of liquidity of insurers, pensions funds and other large investors into supporting this strategic trade is an exciting goal. Any ideas?

References:

1. Asian Development Bank assessed a trade finance gap of \$1.6trn in 2016
2. The ICC Trade Registry, which in 2016 analysed US\$8.5trn exposures and 17m transactions show default rates between 0.04% and 0.21% depending upon the trade instruments
3. See TFR July August Le dernier mot at: <http://www.tfreview.com/opinion/commodities/le-dernier-mot-7>

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