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Trade finance funds: Confidence dips on Shinhan retreat

Shinhan Capital's recent redemptions and BAF Capital's winding down of BLTFF have focused attention on inefficiencies in the trade finance fund market. The extent of the ripple effect on investor confidence has yet to be seen, but it is likely there will be some casualties among less specialist fund managers that have entered the trade space.

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TRADE (/HOME/SECTOR/5952/TRADE)

The commodity trade finance fund market is feeling the fallout from a major investor – Shinhan Capital – calling in a number of sizeable redemptions and at least one key fund packing up completely. The ripple effect has put a temporary damper on sector growth and prompted funds – particularly those that are still backed by Shinhan – to attempt to assure investors they remain stable.

Shinhan Capital redeemed its investment in several commodity trade finance funds from August 2018 onwards. Although unconfirmed by Shinhan, the redemptions are said to stem from some funds, and a related 12-month bond issuance from the group, underperforming. The move is unlikely to be a complete withdrawal from the trade

finance asset sector – market rumour is that Shinhan will continue to commit at least $500 million for around five separate funds. But the investor is expected to cut its current exposure, said to be around $1.3 billion, significantly.

Shinhan has only been a trade finance investor for around a year-and-a-half, but it is a major investor for many of these funds. Given the niche market only comprises around 20 funds in total and is estimated to be between $5 billion and $8 billion in size, a reduction in exposure by Shinhan would be a major blow to confidence in the seminal but growing trade finance asset class.

Market insiders speculate that a significant redemption from Shinhan contributed to the recent closure of one of BAF Capital's trade financing funds, BLTFF. The collective investment scheme provided short-term secured trade financing (dollar denominated pre-export and import financing) to the agribusiness and energy sector in Latin America. BLTFF had $960 million of assets under management (AUM) at its peak and in early December 2018 had roughly $500 million.

BAF Capital commented that the decision to close the fund was taken on 24 September due to a lack of adequate investment opportunities for the fund in the short- to medium-term. Additionally, the board could not foresee performance returns of the fund improving.

BAF Capital has confirmed it has no problems with its credit fund BLCF, which has $750 million of AUM. The investment manager is holding discussions with investors regarding the conversion of the BLCF fund from an open-ended into a closed-end fund to harmonise the portfolio maturity with distributions to investors.

IIG Trade Finance's fund is also facing troubles according to market rumour, but it is unclear to what extent and if it will require liquidating too. IIG Trade Finance gave no comment when approached on the subject.

Redemption drivers

Redemptions are not always directly related to a fund's poor performance or management. Rising local benchmark rates, which may have been an influence on Shinhan's exit, can also be a key factor. As a manager at a leading trade finance funds tells TXF: "The traditional Asian investors – the Japanese and, for the past two years, the Koreans – are starting to pull out for various reasons. The base lending rates are going up and therefore so is their cost of hedging. An Asia-based investor, at the current Libor rate, will expect no less than

4% to 5% per annum otherwise the cost of hedging is too high. So, if you are not providing them at least superior returns they have no interest to see you."

Typically, a fund will also have a number of safeguards incorporated into offering memorandum agreements to mitigate redemption risks. For example, a 'gate' will be incorporated to set a maximum limit on what an investor can redeem periodically, and a soft-lock can be used to enforce penalties on investors that redeem early – usually within the first two years.

In a situation where redemptions exceed short-term liquidity the fund can limit redemptions through these mechanisms, but if too severe then the responsible action by a fund is to self-liquidate: it would be irresponsible to use free cash to make up for redemptions since this only increases the risk for loyal investors.

Market speculation is that Shinhan may have offered to pay higher fees with its sizable tickets in return for such mechanisms being dropped from offering memorandum agreements.

Other funds, particularly those that are still backed by Shinhan, are now trying to contain the effects of these events and assure worried investors that their funds are not affected and remain robust and stable.

However, concerns that other funds could face liquidation unexpectedly are resonating throughout the market. As one fund manager says, "Shinhan's exit, along with the stress it caused for certain managers, only exacerbated existing inefficiencies, be that of the market these managers were focusing on or their portfolio/management. Other investors are also pulling out based on similar region-specific or manager-centric issues. Some of the managers are either underperforming and/or not performing as they should in terms of management. The asset class is going through a period of consolidation and the stronger and more professional funds will survive, but the "mum & pop" shops will not."

An institutionalising market

Prior to the Shinhan ripple effect the commodity trade finance market was picking up traction with institutional investors. Nicolas Clavel, CIO at Scipion Capital (a fund not associated with Shinhan) tells TXF: "The market has been gradually institutionalising over the last three to five years, and over the last 18 months we've seen much more of this."

Institutional investor interest in trade finance funds has been fuelled by the promise of good returns with low risks and low volatility. Trade finance funds can offer mid-6% to 8% returns with other additional attractive features such as inflation protection, liquidity, and uncorrelated yields to stocks and bonds.

Trade finance funds still heavily rely on European family offices, and the transition to more institutional investors has been helping boost the quality and depth of their investor base. "European institutional investors are still looking at the asset class a lot. The US is waking up, but they believe the asset class is too small and offers no depth to their institutional investors. The traditional Asian investors are starting to pull out for various reasons, but there is still interest from all over the world," says the fund manager.

Despite the growing appetite, getting institutional investors to understand just what they are investing in is still a challenge. Trade finance as an asset class remains under the radar for the bulk of institutional investors. And it doesn't help that there is no global standardisation in the terms used in trade finance either, nor that there is no asset class specific information available on Bloomberg Terminals – the first point of call for most investors.

Still room for growth?

Although the asset class remains relatively small, it has been around for about 15 years and grown significantly in size. There are around 20 viable funds/asset managers for institutional investors to consider with a collective AUM of $5-$8 billion – although the figure is likely to be closer to the bottom end of this scale given recent developments.

What is certain is that there is ample demand for trade finance. The global trade finance gap was estimated at $1.5 trillion in 2017 by the Asian Development Bank (ADB). And as banks continue to retreat from the sector, due to tightening Basel capital requirements and associated balance sheet constraints, more borrowers are turning to funds for financing.

However, barriers to entry for new funds are by default high and the recent events in the market are only raising them. For starters, a trade finance fund is expensive to run, requiring lengthy due diligence trips and processes. The upfront capital required is in the tens of millions of dollars and a track record with potential investors is almost essential. Then there are the necessary human resources – both local and industry expertise is needed.

To date, the drivers for growth of trade finance funds have also put limits on potential future development. As Jean-Francois Lambert, founder of Lambert Commodities, explains: “Working in emerging countries and taking on riskier business enables funds to generate the returns expected by investors. However, while investors maintain mid to high expected returns from trade flows, the potential growth of trade funds is limited.” In short, the bulk of trade finance borrowers cannot support the margins required by funds, and lower margin bank debt will always constitute the major share of the market.

Another potential damper on growth is that the development of many trade finance funds was originally fuelled by excess liquidity caused by very low US dollar interest rates. Now interest rates are rising again, trade finance has a wider asset universe to compete with.

But even allowing for potential constraints to growth, the fallout from recent market events and a probable period of fund consolidation, “the industry is bound to grow” says Lambert. “But it is not going to grow to the point it will actually compete with banks. As long as investors can get low risk and strong returns they are happy, but this is not an easy equation to maintain in the long run,” and not one the majority of developed market trade finance borrowers will be willing to sustain.

BAML's Brady looks at trade with fresh eyes

A wave of new trade hires has provided Bank of America Merrill Lynch with an opportunity to focus on its strengths and leverage inherent advantages over competitors. TXF spoke with Geoffrey Brady, recently appointed as head of global trade and supply chain finance, about the direction in which the bank is moving.

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Over the past two years, Bank of America Merrill Lynch's trade team has been transformed by a succession of appointments and new hires (https://www.txfnews.com/Tracker/Details/64c6970c-246c-47c8-93f5-abc6f18f3243/New-trade-roles-for-Jameson-and-Kalay-at-

Bank-of-America-Merrill-Lynch). The three-pronged structure of the trade division – traditional trade finance, supply chain finance, and export and agency finance – may not be unique, but there is a determination to embrace fresh perspectives on how the bank approaches trade.

Geoff Brady heads up the trade and supply chain finance on a global basis, having recently moved over from JP Morgan. He joins Fiona Deroo head of North America trade and supply chain finance product sales; Lesley McNamara, head of global trade product and strategy; David Trecker, supply chain product head; and Patrick Gang, traditional trade and export and agency product head. Brady reports to JP Jolly, head of financing and channels, and heading up all of global transaction services is Faiz Ahmad, also both relatively new to their roles.

“Patrick is relatively new, and Leslie and David have both been promoted into their roles in the last 18 months or so. In that regard we are somewhat of a new team. All of this new blood allows us to take a fresh look at the GTS business. Both through internal moves and external hires, we have the ability to look at things through a different lens and hopefully bring a fresh perspective to the trade business,” says Brady.

Having joined from a competitor institution, Brady was well aware of the bank’s key strengths and capabilities: “Bank of America’s key strength is the sheer breadth of its corporate relationships in the US, from large corporations to deep into the middle and commercial banking market. If you look at a business such as supply chain finance, we act as a financier between a buyer and all of their suppliers, and the commercial relationship that they have. We are also the bank to a lot of those suppliers through our extensive franchise, and that makes us especially effective and competitive – a significant advantage for us. Beyond that we also have a broad global footprint which is obviously important in trade. I’ve always thought this about the bank, and it has been validated since I joined.”

Brady and the team are hard at work articulating the trade and GTS strategy to the wider organisation, explaining areas of focus and where partnerships are possible. One aspect they are keen to focus on is connectivity between the trade business and the markets. “We need to look beyond the bank market for distribution and widen that avenue into the capital markets, as the trend is certainly in that direction, especially for supply chain finance and export & agency finance. We need to explore how this is happening across the credit spectrum, not just in trade and supply chain finance, but also in general bank lending. There will be a greater emphasis on using the markets; credit

trading, short term investments, etc, to bring in some of the discipline that creates more touch points with the broader investor universe. I think it is incumbent on us to have the most robust distribution capabilities to reach that wider base, because if you think of supply chain programs at large firms, we tend to run pretty big tickets. Distributing into the capital markets as efficiently as possible, and of course also using our partner banks and third-party platforms, is going to be increasingly important," says Brady.

It would be fair to say that the export and agency finance pillar of the bank's trade offering has not necessarily been a focus in recent years, but Brady assures that there will be more deal flow going forward – both participating in larger transactions and originating new deals.

He says: "It will be a little of both initially. We have a team that includes experienced individuals, some new to the bank and some that have been here a while, that have a history of originating deals, and have relationships out in the industry on that front. As one of the cornerstone relationship banks for a lot of clients on both the buyer-side and the seller-side in export finance, I think it's fair to say that there has been some surprise that we haven't been more engaged on the origination side in the last year or so. However, as a leading bank that is looked on favorably, and seen as a thought leader, there is demand there for us to support clients across all aspects of trade – so origination will feature as part of that in the near future."

Musing over the opportunities present in the wider trade space, Brady thinks that the market can sometimes be distracted in looking for the next big thing: "The industry buzz is always around the technology – the new thing is always the most fun, and a big screen on a wall running a demo can give you this window to the future. That's an important part of the conversation, but what I personally think is more important, and the real story of trade finance over the last ten years or so, is the dramatic growth in supply chain finance. I don't think we've ever seen such explosive growth in a segment of trade finance before. We are now at a point now where every large corporate in the US, and indeed globally, has either implemented, is implementing, or is considering implementing, a supply chain finance program to optimise work capital, and to maximise what could potentially be free cash flow."

He adds: "This is a story not just about origination, but also one of improvement. Can we do it better? How can we make more capacity available? How can we do more? How can we reach more suppliers with our programs? I think the criticism of supply chain finance has been that it's great for the top, high value strategic suppliers, but how can we make it more impactful for the lower value non-strategic

suppliers? And that's where as an industry we should be figuring out how we can make this available through technology, through different distribution platforms, through different on-boarding platforms, to make this the thing that sustains the growth for this business and also creates value for our clients. It's where we as a bank focus a lot of our energy and resources in terms of technology. Concentrating on what improvements we can make in the short-term."

A question that is frequently asked when it comes to technological innovation in trade finance, is what is actually deliverable, and in what sort of time frame? Brady is frank when it comes to the history of trade finance and technology: "As an industry, we've not really been able to cross a threshold for using technology to make our business simpler and more efficient. Beyond what we were able to leverage through the spread of the internet, there haven't been any dramatic improvements. There have been initiatives that have come and gone over time, but I don't think we've materially moved the needle on how we originate and improve the flow of transactions."

He continues: "Now, the conversation has moved on to distributed ledger and blockchain, and we've seen proof of concept demonstrations, so we know technologically the direction in which we are moving, but the question of implementation is yet to be addressed. How do we make this accessible, widely disseminated, with low barriers to entry? Those conversations are going on right now, and the good news is that there is more collaboration now around technology in the trade finance space and there has ever been.

"Behind all of that is the standardisation question – and there is a lot of hard work to be done, which is challenging, but will lead us to more opportunity. I like the analogy of that we can have a choice of portal – like a web browser – but the rules that govern those portals and the content you access are the same."

With trade never far from the headlines at the moment given the escalating tensions over tariffs and free trade agreements. Many banks are having to pay close attention to how their customers are reacting when it comes to positioning supply chains and other considerations.

"As a bank we are always talking to clients and asking them questions to take the temperature of the market and extrapolate what that might mean for us. Currently for our clients, it's often about taking precautionary measures, and I think that can also create opportunity. There will be spikes and dips connected to the headlines – for example, a year ago there was a lot of anxiety around the future of NAFTA, but then a deal got signed and the conversation moved on. We are in a very different political environment globally. Many of our

clients are telling us that they are aware as always, but they are not making any huge moves yet as there is still so much uncertainty. It underlines the fact that it is always useful to optimise working capital to be responsive to situations as they arise."

Recent changes to US tax law have also raised the question of whether clients' treasurers should look at cash repatriation. Brady adds: "It is definitely a part of the conversations we're having. Part of it is going to be a currency pooling conversation, part of it is a trade finance conversation, and part of it's a liquidity conversation. Having those three aspects all in the same group is where we see the real benefit – you can take a holistic view. It is also a two-way conversation, as we are going to want to hear their ideas too. Ultimately if a client wants to repatriate cash, we are there to think about how they can optimise that cash to make it work better for them."

New hires and appointments in Bank of America Merrill Lynch's Global Trade and Supply Chain Finance team

- Geoff Brady, head of global trade and supply chain finance (joined in Aug. 2018)

- Peter Jameson, head of trade and supply chain finance, Asia Pacific GTS (appointed in Nov. 2018)

- Baris Kalay, head of trade and supply chain finance, GTS EMEA (appointed Nov. 2018)

- Duncan Lodge, head of product management for trade and supply chain finance, GTS EMEA (joined July 2018). He reports to Baris Kalay. He was previously at Lloyds Banking Group where he was responsible for strategy and Innovation within trade and supplier finance product.

- Patrick (Pat) Gang, head of product for North America traditional trade and Export/Agency Finance (joined July 2018). Previously he was at JP Morgan for 12 years where he worked in trade finance and export agency finance. Pat reports to Lesley McNamara, head of global product management and strategy for trade and supply chain finance