Trade Finance - Developments in Trade

Key Highlights

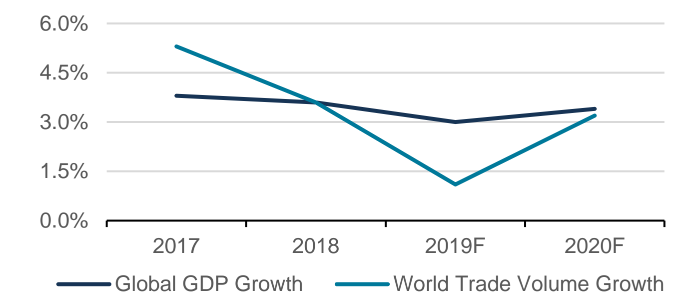
- The US-China trade war is expected to be resolved soon, with both sides optimistic about signing phase one of a trade deal.
- Trade Finance is increasingly being recognised as a low risk asset class and has started to appeal to institutional investors.
- The sector presents significant investment potential, given the huge funding gap of $1.5 trillion, or about 8%-10% of global merchandise trade, which disproportionately affects small and medium sized firms.
- Adoption of technology is expected to yield positive results in bridging the trade finance gap.

Global Trade Expected to Pick-up Next Year

The protracted US-China trade war finally seems to be nearing an end, following an agreement between the world's two largest economies on a partial deal. Inking "phase one" of the deal is expected to take a few more weeks, though any form of trade agreement is a welcome sign for the global economy which has been battered and bruised over the last 15 months due to uncertainty surrounding the future of global trade. In agreeing to a deal following several rounds of talks, both countries seem to have come a long way from the trade impasse that began in July last year and included multiple tit-for-tat tariff hikes witnessed as recently as this August. Although escalated tensions between the two countries over the past year has led international agencies to downgrade their forecasts for global economic growth and trade multiple times, the outlook appears to be recovering.

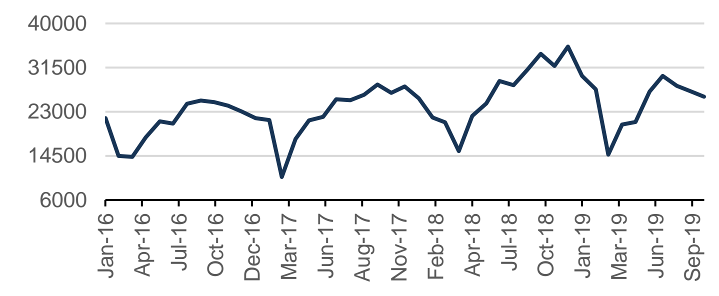
The International Monetary Fund (IMF), in its October 2019 World Economic Outlook report, slashed its global economic growth forecast to 3.0%[1] for 2019, down from 3.2% projected in July this year. However, the IMF expects global economic growth to pick up to 3.4% next year and global trade volume to grow by 3.2%[1], a significant rebound from the expected growth of 1.1% in 2019. The trade deal, expected to materialize sometime during early next year, is likely to result in additional demand for trade finance, providing attractive opportunity for investors.

Global GDP Growth and Trade Growth



Source: IMF[1]

China - Trade Balance with United States (USD Million)



Sources: Bloomberg

Trade Finance is Gaining Recognition as an Investible Asset

While the trade finance market has historically been almost exclusively the business of banks and more or less off-limits for institutional investors, low returns in traditional investments together with standardization across the trade finance industry have changed opinions of these investors about trade finance. According to market research company, Technavio, the global trade finance industry is expected to grow at a compounded annual growth rate (CAGR) of over 4%[2] during the 2019-2023 period. Benefits of trade finance as a low risk asset class, coupled with its uncorrelated nature and attractive returns, makes it a sensible addition to a portfolio that is diversified and hedged.

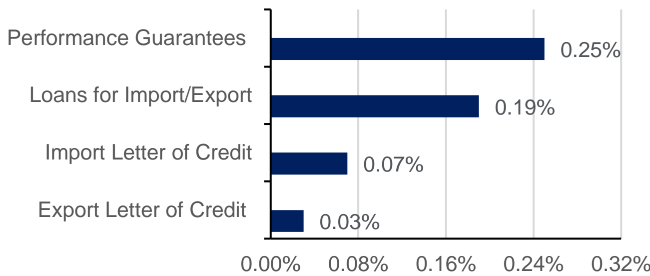
Low Risk Asset; Offers Securitization

According to the 2018 International Chamber of Commerce's (ICC) Trade Register Report, default rates for trade finance from 2008-2017 were low across all products and regions. Further, this asset class also offers securitization, thereby enabling financers to grant funding with reduced credit risk. This funding against account receivables gives companies continued access to finance even when they experience sustained losses and banks are unwilling or unable to lend money through alternative means.

Uncorrelated Asset Class; Attractive & Consistent Returns

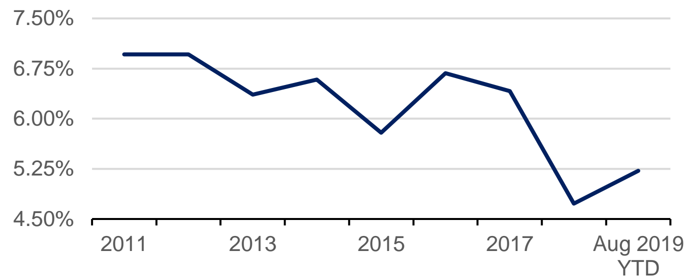
According to S&P Global, there has been an increase in the number of trade finance funds globally to meet demand from institutional investors seeking attractive returns with low correlation to traditional asset classes. According to Eurekahedge, a Singapore-based research firm, trade finance-focused hedge funds reported an average return of 4.73%[3] in 2018, despite the US-China trade war. At the same time, the MSCI World Index returned about -10.4%[3] and iBoxx Investment Grade Bond Index returned around -3.7% in 2018. These funds have continued to grow this year, with returns of 5.22%[3] in the first eight months of 2019. Furthermore, a 2017 report by market intelligence company, Greenwich Associates, highlighted that even during the worst of the financial crisis, the asset class did not post a single month of negative returns.

Trade Finance Default Rate by Products (2008-2017)



Source: 2018 ICC Trade Register[4]

Eurekahedge Trade Finance Hedge Fund Index Performance



Sources: Eurekahedge[3]

Rising Standardization, Technology Adoption and Better Regulations Provide Comfort

The Trade Finance industry has continued to evolve since the global financial crises, owing to stricter regulations which have ensured greater transparency, demand for due diligence and standardization, providing better flow of information for investment managers. Further, the adoption of technology in trade finance is expected to enhance operational efficiency, reduce costs, and improve risk management. This, together with increased awareness about the trade finance industry is likely to promote trade finance as an attractive asset class for investors. Recently, a group of 14 financial institutions, including Deutsche Bank, HSBC and Lloyds Bank, have come together for the Trade Finance Distribution (TFD) initiative, to create a trade finance market where assets can be purchased and sold efficiently. The TFD initiative is expected to attract pension funds and other non-bank entities to invest in the asset class.

Persistent Shortage Worth $1.5 Trillion Between Supply and Demand for Trade Finance

Apart from the US-China trade war that has weighed on global trade, and resultantly on the trade finance industry, another major concern for the industry is the 'trade finance gap'. According to the Asian Development Bank (ADB), there is a $1.5 trillion[5] gap between global demand and supply of trade finance and access to trade finance is disproportionately skewed towards large firms, with 45%[5] rejection rate of SME proposals, compared to 39% of mid-sized and larger-sized firms and 17% of multinational corporations. A recent survey by BNY Mellon highlighted that constraints related to compliance, including high compliance costs, are the primary contributors to rejections.

Stricter Regulations Following Financial Crisis Led to Trade Finance Gap

The ICC believes that the $1.5 trillion trade finance gap is an unintended repercussion of the global financial crisis, as stricter anti-money laundering and Know Your Customer (KYC) regulations were drafted in the aftermath of the 2008 financial meltdown. While these regulations were designed to ensure financial security for trade transactions across the world, they resulted in restricting access to much-needed financing for the MSMEs, especially in emerging markets. The rejection of MSMEs is also due to lenders' obligations to comply with regulations related to countering financing of terrorism and higher Basel-III capital requirements.

SMEs account for significant portion of the trade finance demand and the limited access to trade finance lowers the economic participation of SMEs and limits their job-creating ability and growth prospects. Continuation of this trend would negatively impact business growth in emerging markets, which would eventually be detrimental for the global economy.

Initiatives are being Taken to Address the Trade Finance Gap

The United Nations Economic and Social Council has committed to promoting policies that encourage adequate and affordable trade finance access to MSMEs at all levels. The G20 and the OECD have also established principles to strengthen financial market infrastructure for SMEs and have recommended an aggressive adoption of digital tools to ensure increased transparency throughout a transaction's lifespan, thereby enabling SMEs, particularly in emerging markets, to mitigate the risk perception associated with financing their transactions.

Technology Holds Great Potential to Bridge the Trade Finance Gap

Efforts are being taken to explore the role of digital capabilities in trade finance, with the viewpoint that a technological approach could significantly improve current procedures, including streamlining compliance processes, while also reducing operational and compliance costs. The ICC has laid out several measures to facilitate and accelerate the use of digital technology in trade and trade finance, including collaboration between banks, fintech firms, corporates, SMEs and regulators, digitization across the ecosystem of buyers, sellers, banks and stakeholders across all verticals.

Technology is One of the Two Priority Solutions to Address the Trade Finance Gap

Source: BNY Mellon Survey[6]

Digitization and Centralized KYC Could Help in Resolving Issues Related to Compliance

Digitization and Centralised KYC have been at the forefront of the discussions to resolve issues related to trade finance gap. According to Southeast-Asia's second-biggest lender, Oversea-Chinese Banking Corp Ltd. (OCBC), forgers have become skilled at creating fraudulent documents, and therefore, the business of financing global trade needs to go digital. The digitization of trade documents is expected to smoothen the process of maintaining KYC database, which will further aid in addressing compliance issues according to the BNY Mellon survey. In this regard, multiple initiatives are already underway, with blockchain and non-blockchain KYC solutions continuing to emerge.

Blockchain to Enable More Efficient Trade Transactions

Blockchain is expected to play a major role in transitioning from old paper-based methods to digitization of documents. Blockchain, being transparent and cryptographically secure, is an ideal platform for KYC checks and the use of this technology to automate and centralize KYC processes could potentially reduce compliance and operational costs and shorten the time required for onboarding new clients. A soybean shipment of Cargill, an American agricultural producer, in May 2018 was the first live end-to-end trade finance transaction on a scalable application for a fully digitized letter of credit, using blockchain. Notably, the document exchange and checking time for the transaction took place within a day, compared with the usual period of 5-10 days for a traditional, paper-based process.

Better Prospects Lie Ahead for Trade Finance Industry

US-China Trade war and the trade finance gap have been the stumbling blocks lately in the growth prospects of the trade finance industry. The trade war is a political issue and while recent events paint a picture of optimism, our view is that it is in the interest of both the US and China to reach a comprehensive and permanent solution at the earliest. Meanwhile, numerous global institutions and agencies are coming together to widen access to trade finance in order to address the large unmet demand for such trade financing. In our opinion, the use of technology could widely benefit global trade finance and global trade as a whole. We believe that the collaboration of various technologies such as blockchain, artificial intelligence and machine learning could considerably boost trade and trade finance activity in the near future.