African Trade Finance

Briefing

Prepared for Global Sustainable Capital Management (UK) Limited by the Sauder Centre for Social Innovation and Impact Investing

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A. Background

According to the Asian Development Bank survey the global trade finance gap for 2018 is estimated at around USD1.5 trillion with 60% of the banks surveyed expecting that gap to grow in the next two years. A survey by the African Development Bank suggested that the Trade Finance gap on the African continent is $90bn and represents a major barrier to growth for exporting countries. With the global supply chain penetrating further into less-developed markets, the World Economic Forum predicts that the number will jump to USD2.5 trillion by 2025. Growth in trade with emerging markets is important to the achievement of the Sustainable Development Goals; sustainable trade has the potential to alleviate poverty and to promote economic growth. The Trade Finance gap represents a significant barrier to the growth of sustainable trade overall, as exporting companies face barriers to fulfilling the global demand for commodities and resources.

Access to trade finance remains disproportionately skewed in favor of large firms. The 2019 ADB Trade Finance Gaps, Growth, and Jobs Survey shows that the rejection rate of SME financing proposals is 45%, higher relative to mid-sized and larger-sized firms (39%) and multinational corporations (17%). There are a number of factors driving the high rejection rate of these firms including the high fixed costs of due diligence and KYC processes for larger lenders. Returns from Trade Finance transactions have been robust and as we will discuss below, default rates remain very low. The ICC Trade Finance register reported default rates of 0.03% and 0.24% and a transaction weighted default rate of 0.01% for the period 2008-2017 for Export Letters of Credit. Nonetheless, investors view the low credit ratings of countries as a major barrier to Trade Finance.

B. Business Model

Trade Finance Definition

Trade finance is the provision of dedicated funding to support the movement of merchandise traded along a supply chain. The supply chain is typically international (cross-border), but as lenders engage further along a chain, elements of domestic trade may appear.

Transaction Modes

Trade finance transactions typically involve the following modes:

- **Trade Finance (TF)** is the basic trade finance instruments which include Letters of Credit, Guarantees/Standby LCs, Bid and Performance bonds, Acceptance & Discounting of Bills of Exchange, and Import or Export Loans. Typically, in the event of a default, the lender looks to the balance sheet of the borrower and may or may not have immediate recourse to the underlying goods, which are typically general merchandise.
- **Commodity Trade Finance (CTF)** is defined to differentiate the transactional commodity trade lending to general borrowers from balance sheet lending to investment-grade commodity firms, Commodities in this context are raw material inputs for food, energy or manufacturing. CTF usually is asset-backed, short-term with often repetitive deals and typically for strategic or essential commercial inputs.
- **Receivables Finance (RF)** may take the form of discounting a specific or a pool of third-party invoices or book debts, with or without recourse to the seller. Because underlying goods will pass hands, lenders typically take out credit insurance to provide a backstop. Where all conditionality has been met (including insurance), and the underlying receivables are due and payable, an RF portfolio offers good investment opportunities for investors.
- **Supply Chain Finance (SCF)** is different because instead of financing a bilateral trade between two parties along a supply chain, the lenders look to the ultimate receivable at the end of a chain to finance the various suppliers down the line. It is an expansion of Receivables Finance.

- **Structured Trade or Structured Commodity Finance (STCF)** tends to involve more medium to long-term financings for either commodities or capital goods, which may be backed by an Export Credit Agency (ECA) or secured by an asset-backed borrowing base (usually of commodities or their receivables).

Common Features

Regardless of tenor, commodity, flow, or means of transport, the vast majority of trade finance transactions share some common features:

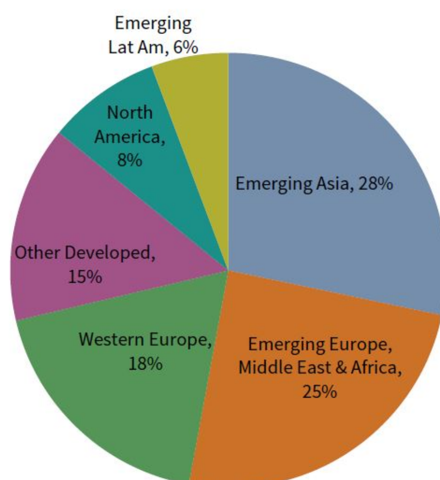
- **Clearly Defined Terms, Conditions, and Covenants**. In addition to tracking the financial performance of the borrower, trade finance ties events of default and other conditions to certain performance benchmarks, akin to a project financing or construction loan. Also, most trade finance is denominated in a hard currency like USD.
- **Transaction Oriented**. Trade finance provides capital for a clearly identified transaction of finite life that is evidenced by a contract that specifies goods, timing, payment, price, and other requirements. Trade finance does not provide long-term capital for general corporate purposes.
- **Usually Involves Shorter-term Assets**. Even the longest exposures will typically not exceed two years. As a result, asset turnover is high, permitting finance lenders to adjust lending rates in response to the market, thus greatly mitigating duration risk.
- **Require Some Form of Recourse for the Lenders**. Lenders must at least have a first priority lien on the goods for which they are financing production, manufacture, and shipment. Providers of trade finance can also obtain a corporate guarantee for credit enhancement.
- **Often Involve International Trade**. Most transactions involve the import and export of goods carried over long distances and using different modes of transportation.
- **Heavily Exposed to Emerging Markets**. Developing countries typically benefit from a surfeit of commodities while lacking sufficient financial capital. Ultimate payment, however, frequently comes from purchasers in the developed markets, who pay in hard currency, thus reducing currency risk.
- **Relatively Low Default and Loss Rates**. According to the data from the International Chamber of Commerce (ICC) 2017 Trade Register Report, default and loss rates (about 0.2%) in trade finance have been significantly lower than that for other traditional credit products.

Market Trends

Asset management firm Cambridge Associates notes that, rising regulatory requirements since the latest financial crisis in 2008 have caused banks to respond in two ways in the trade finance market. Firstly, they have moved to an “originate and distribute” model under which large banks structure trade finance instruments and sell off participations to reduce their overall exposure (an approach similar to the traditional syndication of loans and bonds). Secondly, banks have increasingly focused on clients that have the lowest compliance risk. This focus has led to the neglect of small and medium-sized enterprises (SMEs), particularly those in the emerging markets.

The Asian Development Bank estimates that the unmet trade finance need in Asia alone was US$1.5 trillion in 2018. As a result, institutional investors have gravitated to SMEs in the emerging markets. The Middle East, Africa, Asia, and Latin America account for 40% to 50% of total global trade in manufactured goods and the WTO further estimated that trade in goods among emerging-market countries amounted to US$5 trillion. Correspondingly, a majority of trade finance transactions originate in the emerging markets (See Exhibit 1).

Exhibit 1 ORIGIN OF PROPOSED TRADE FINANCE TRANSACTIONS BY VALUE (2017)



(Source: International Chamber of Commerce, "Rethinking Trade and Finance, 2017)

Another trend noted by the ICC in its 2015 Global Trade and Finance Survey was the emergence of non-bank alternative credit players. Private funds are becoming more prominent as barriers to entry fall and regulations favour non-banks for some asset classes. Non-bank players have always been a part of the trade finance and span a wide range of services, from lending (most commonly Receivables Finance) to logistics, platform and technology provision, insurance and other products and solutions linked to trade finance.

In addition, Basel III liquidity requirements have made certain asset classes less expensive to house on a non-bank balance sheet. This shift in the relative attractiveness of holding assets on bank vs. non-bank balance sheets, combined with a hunt for low-risk investments with good yields, has also led to investors coming into the market. Consequently, some asset managers and hedge funds have started looking at trade assets as a potential asset class. The most straightforward opportunities relate to small size transactions and cases where a borrower has used up its bank credit lines.

Trade Finance Fund Strategies

Trade finance funds have emerged to assume risks that banks either want to share or avoid altogether. According to research by Cambridge Associates, trade finance funds typically assume these risks in three ways: Participation, Replication, and Regulatory Relief (See Exhibit 2).

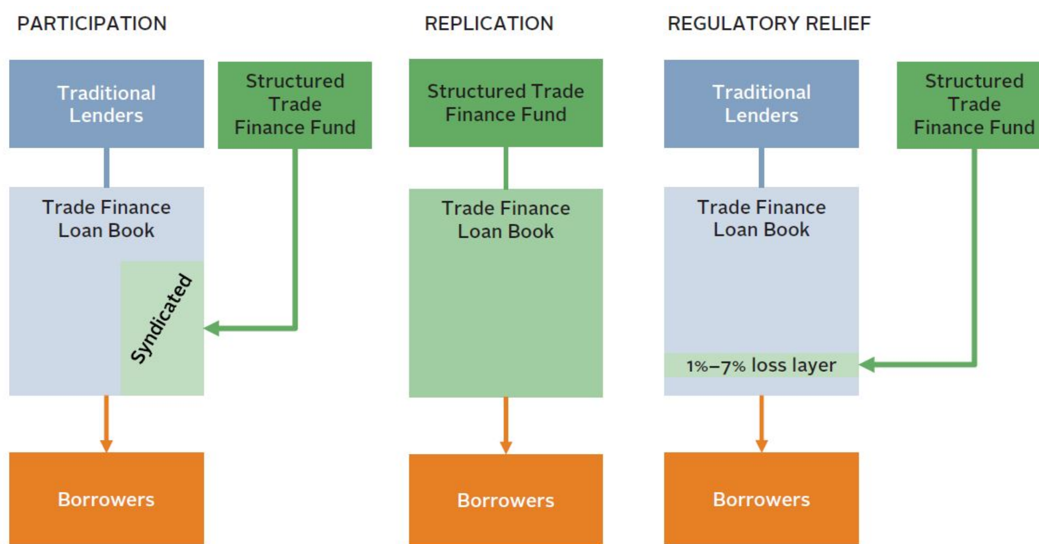
Participation

Participation refers to strategies that share in the risks assumed by trade finance banks by purchasing an obligation from a bank that has originated and arranged a loan (i.e. banks pursuing the “originate and distribute” model mentioned above

Replication

The Replication model seeks to mirror the origination and arrangement activities of larger banks, but with smaller borrowers. Trade finance funds pursuing this strategy frequently extend credit to smaller domestic manufacturers or trading houses, which for some reason do not have access to bank funding for part or all of their needs.

Exhibit 2 WAYS TRADE FINANCE FUNDS ASSUME RISK



(Source: Cambridge Associates LLC, 2018)

Regulatory Relief

The Regulatory Relief model applies first-loss, risk-sharing principals common in the banking and structured finance worlds to trade finance. Under a first-loss arrangement, a trade finance fund would agree to share in losses of a bank's trade finance portfolio on individual loans up to a certain amount. For example, a fund may agree to fully bear or share in losses after the first 1% and up to the first 7%, at which point the bank would agree to begin assuming losses completely.

Key Success Factors

The key to any investment in trade finance is the ability of the fund manager to deploy funds, for which there are various opportunities along the transaction chain (See Exhibit 3). For fund managers, it's then a question of which trade finance funding opportunity best meets the risk and reward profile of the fund.

Exhibit 3 OPPORTUNITIES IN THE TRANSACTION CHAIN

(Source: Kimura Capital, LLP, 2018)

Risk management is another key differentiator. An experienced and dedicated team of specialists has a higher potential to meet the demands of the trade finance business. Knowing what to look for, but more importantly, how to manage and mitigate the risks arising along a transaction chain is the

crucial skill of an experienced trade finance practitioner.

Among all the risks, fraud is the main cause of loss in trade finance, and this risk is exacerbated where the lender doesn't have sufficient market knowledge or expertise to spot it or to take steps to prevent it.

The opportunity to fill the Trade Finance gap is significant but requires a comprehensive and committed approach to deal qualification, KYC and transaction management. If the goal is also to support the SDG's then any approach to sustainable Trade Finance will need to address the non-financial social and environmental risks associated with the commodity or product that is being financed.

Resources

ADB Briefs, 2019, Trade Finance Gaps, Growth and Jobs Survey, No. 113. September.
African Development Bank Group, 2017, Trade Finance in Africa: Overcoming Challenges.
International Chamber of Commerce, 2016, Rethinking Trade and Finance, ICC Private Sector Perspective
International Chamber of Commerce, 2018, ICC Trade Register Report.

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