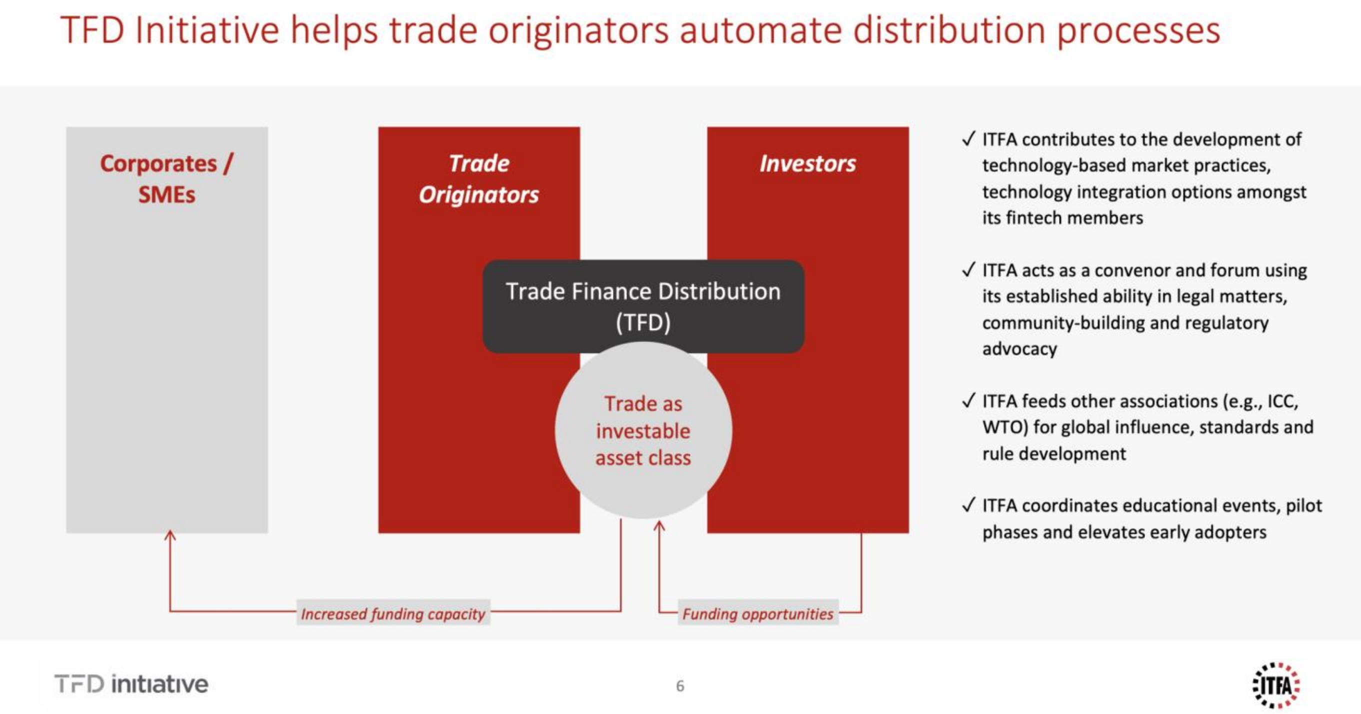
Making trade investible for institutional investors - banks make it

By André Casterman, Founder and Managing Director, Casterman Advisory and Chair of Fintech Committee, ITFA

Collaboration, Innovation, Standardisation and Education were the keywords that our panellists representing HSBC, Reed Smith and Santander Asset Management highlighted during our recent TFD Initiative webinar. The session demonstrated how making trade investible for institutional investors is being achieved by top players in the industry, and how new long-term partnerships will help fill the trade finance gap.

The Wall Street Journal of 22 January 2020 featured an article entitled "**Money managers, Lured by Rich Returns, Venture Into Risky World of Trade Finance**": "… large money managers buy trade-finance assets that lenders have already originated instead of funding importers and exporters directly. Often these assets are wrapped up into asset-backed securities.". In this article, **Surath Sengupta, global head of FIG, Portfolio and Distribution at HSBC**, said "HSBC has increased the trade financing it sells on to investors and other lenders from $2 billion in 2015 to $28 billion last year [2019]."

This illustrates a key trend as originating banks are expanding their distribution network to new types of funders in order to grow their own trade financing capacity. Rather than limiting themselves to the niche inter-bank space, more banks start partnering with a range of institutional investors and are therefore making trade assets more accessible to those non-bank funders through securities formats such as asset-back notes.



This is a strategic theme for the ITFA membership which is why I invited the following early adopters of TFD Initiative:

Speakers

ReedSmith	Santander Asset Management	HSBC	CASTERMAN ADVISORY
Nick Stainthorpe Partner Reed Smith LLP	**Bertrand de Comminges** Global Head Trade Finance Investments Santander Asset Management	**Surath Sengupta** Global Head – FIG, Portfolio and Distribution, HSBC and Co-Chair, ICC's working group on Institutional Investors in Trade Finance (IITF)	Moderator: **André Casterman** Founder Casterman Advisory and Chair, Fintech Committee, ITFA

TFD initiative

We collected the following take-aways and questions from the audience.

Take-aways on working with institutional investors

- Trade finance is attracting new funders that recognise the key attributes of this asset class; particularly the absence of correlation with other investment classes. The ESG priority on the asset management side is also triggering higher interest for trade finance given the sustainability-related transparency that trade flows offer.
- In order to make trade finance more accessible to institutional investors, we need to build the bridge between the two spaces: trade finance and capital markets. This way, trade finance assets will become accessible outside the traditional inter-bank and credit insurance spaces.
- Trade finance is traditionally supported by banks' own balance sheets. The Master Participation Agreement (MPA) is well suited for expert investors such as banks' trade finance teams. However, in some cases, institutional funders can only invest in securities (e.g., notes) as required by their mandate. This is why trade assets need to be repackaged into such notes via a Special Purpose Vehicle (SPV).
- Asset-backed notes are widely used in the capital markets across a multitude of investment classes. For example, the use of notes would facilitate the role of asset managers and other institutional liquidity providers investing in trade assets originated by top banks.
- Some enhancements can be added via the SPV to improve the investment profile of the underlying trade finance assets e.g., insurance held by the SPV, risk reserves and pooling of diversified assets. In trade finance, we often refer to "repackaging" rather than "securitisation" to pass on the corporate risk and reward of the underlying assets to the investor. These SPVs could be independent entities that banks use or may be offered by third-party service providers such as the Trade Asset Securitisation Company (TASC).

Take-aways on types of trade asset transfers

- There are two ways to transfer of assets: (1) funded transfer corresponding to the sale of the asset and (2) unfunded transfer of the risk. The potential is enormous on single transactions or on portfolios of transactions. Both can be supported by a SPVs and securities format (e.g., notes).
- Some institutional investors have developed the appropriate internal trade finance expertise and are happy to participate in transactions via the MPA, but many capital market institutions favour investing through securities - as they do with other asset classes - which is why "repackaging" is the strategic option for banks wishing to engage with those funders. There can be challenges on the regulatory and tax sides but these obstacles are navigable.
- By using "notes", it's possible to grow institutional funding but we need scale volumes under the structures in the short term to defray costs. Banks can also use notes when investing in trade assets, not only institutional investors. In case of default of the underlying assets, the notes structure protects the investors through the physical settlement option: the investors can redeem their notes in return for receiving the assets directly.
- Santander Asset Management runs a Trade Finance fund where the institutional liquidity is pooled. The notes produced by TASC are purchased by the fund. The SPV - TASC in this case - signs MPAs with each originating bank and following Santander Asset Management fund manager's guidance. The whole model is scalable and secure for all parties as the ultimate goal is to bring a stable source of liquidity and high quality investments to, respectively, participating originators and investors.
- Trade Finance historically benefits of lower rates of default than other asset classes. Saying that, fraud risk is a risk that is very difficult to spot for this or any other asset class. Banks may need to find ways to decouple the fraud risk from the credit risk in some situations for institutional investors. There are many ways for banks to mitigate fraud risk thanks to the various touch points and relationships that banks entertain with those corporates. As volumes grow, the diversified nature of many receivables and payables portfolios also help dilute the adverse effects of fraudulent transactions for institutional investors.

Take-aways on the benefits for corporates, banks and funders

- Large corporates and regional companies expect **stable and reliable sources** of liquidity from their banking partners. By relying on a range of institutional investors, originating banks increase their capacity and can serve their clients better and in a more consistent way. In this new model, banks act as intermediators relying on new sources of liquidity.
- For originators such as HSBC, sharing trade assets with institutional funders provides a path to **grow revenues, support clients and develop trade as an asset class whilst lowering capital requirements**, this making the bank is benefiting strongly from such "originate-and-distribute" model by (1) continuously redeploying the capital being freed up thanks to distribution to institutional investors (2) strengthening relationships with its top clients thanks to higher diversified liquidity (3) arranging the right level of liquidity in specific currencies. The impact on return on equity for banks is very positive which is why such activity as become strategic for banks.
- The risk that institutional investors would leave the trade asset class when macro-economical conditions change is low. Once the investors understand the value, the risk profile and yields of trade finance, they remain committed to the investment opportunity that trade offers. The growing importance of ESG will further increase the attractiveness of the asset class.
- Santander Asset Management Trade Finance fund, which is EUR denominated, is attracting multiple type of investors: (1) traditional CP and/or money market investors such as pension funds and insurance companies looking for long-term participations into the fund (2) larger corporate players with significant liquidity looking for more tactical solutions; and, (3) high leverage first-loss investors looking for higher returns. There is a clear market interest in this asset class as presented by Santander Asset

Management. They key attributes of trade finance, paired with the right asset class knowledge and expertise of the Fund managers, make these assets more and more understood by the investors as outlined below:

"For originators such as HSBC, sharing trade assets with institutional funders provides a path to grow revenues, support clients and develop trade as an asset class whilst lowering capital requirements", ***Surath Sengupta**, **Global Head – FIG, Portfolio and Distribution, HSBC and Co-Chair, ICC's working group on Institutional Investors in Trade Finance (IITF)***

"Large corporates and regional companies expect stable and reliable sources of liquidity from their banking partners. By relying on a range of institutional investors, originating banks increase their capacity and can serve their clients better and in a more consistent way", ***Bertrand de Comminges, Global Head Trade Finance Investments, Santander Asset Management***

Questions from audience

How expensive is it to have a trade asset securitisation put in place by an institution? Is the cost depending on size of the portfolio? Or other fixed charges to take into account?

Please contact us for pricing details. The TASC option offers repackaging-as-a-service which is a way to share most of the set-up costs.

Is there a legal mismatching with the instruments underlying governing law, i.e., L/C issued in Bangladesh or Nigeria, and the law governing the SPV?

Please contact Nick Stainthorpe.

Regarding short-term trade finance how can you insure a stable pool of liquidity and preserve client relationships as investors may use such funds as liquidity parking?

Please contact Bertrand de Comminges.

While clients are trusted counter-parties, under stress some clients could commit fraud. As an investor, I would like to know whether you protect yourselves in any way against the fraud risk? Or do you rely solely on the relationship of the lender - borrower?

Please see above key take-aways on fraud risk.

I am interested to hear panellists' views on 1) large corporate clients' whose trade assets are being repackaged into securities cannibalising and contaminating their existing bond yield curve and 2) MNPI issues now that we have a security format and the complicated issues around that.

Please contact Christoph Gugelmann, CEO, Tradeteq.

Investors also participate directly under MRPAs - I wonder if in general Trade Finance, being a relationship driven business, is not often too finely priced to pay for setting up SPVs with all the legal costs related to this.

The Trade Asset Securitisation Company (TASC) offers a way to share those costs.

Do banks make a market in the secondary space for these notes if necessary? i.e., if the investor wants to sell before maturity would the bank buy it back? There would clearly be an illiquidity discount but trying to understand if at all possible. This would be key especially for funds offering daily liquidity.

Please contact Christoph Gugelmann, CEO, Tradeteq.

Webinar deck and reply

Please consult the **supporting presentation** deck and **replay** of this webinar via the ITFA Member Area.