Whitepaper on developing a Practitioners Guide to making Trade an Investible Asset Class

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Foreword

The principles, and requirements, enunciated in this paper are deceptively simple and have been articulated many times before.

So, what is different now?

Simply, the ability to realise these goals is closer than ever to happening. The output of groups such as ITFIE, which brings together bankers, lawyers and fintechs, combines the expertise needed to make these principles real. The fintech community, richly represented in ITFA, is building the digital tools and platforms that the market needs, drawing on experience from both the capital and trade finance markets. Finally, some of the market's most in-touch lawyers are working on the necessary rules and legal principles.

As always, and in line with ITFA's ethos, we look to produce implementable solutions. There is much in this paper to advance that cause.

Executive summary

To improve risk transfer in the Trade Finance market between market players like banks and institutional investors like pension funds, we must take the following three-pronged approach to address challenges and barriers to entry:

1. **Uniform principles**: Develop uniform principles of distribution and market practices, including key terms and obligations of each party as well as terminology to define how such risk distribution and reporting will align to industry needs while avoiding lots of different but similar solutions – see appendix 1 for illustrative scope of such uniform principles
2. **Digital infrastructure**: Create digital and transparent access infrastructure for investors to track and report assets that market players can easily and cheaply connect to
3. **Legal framework**: Initiate a legal directory which would provide a base of key due diligence questions and answers that participants can heavily leverage for individual transactions
4. **Market survey**: survey broad spectrum of institutional investors to get feedback on the above to ensure above actions are guided by market needs – https://itfie2022.questionpro.eu/survey

Background / The Need

The financing of international trade has long been the domain of banks with the bulk of the global market share historically concentrated amongst banks. Trade finance is experiencing a level of visibility unparalleled in its long history and there is clear recognition of the need to widen the trade financing ecosystem and bridge the trade finance gap to support the global supply chains that are the arteries of trade. This includes SMEs based in developing and emerging markets, where the challenges in accessing affordable trade finance are most acutely felt.

At the same time, there is an increasing demand from non-bank investors for low-risk, uncorrelated short-term assets which give positive yield and finance the real economy. These investors do not have the expertise and/or infrastructure to lend directly in support of global trade, and depend on banks to provide them with, and act as the channel for, quality investments.

It is widely acknowledged that banks alone will be unable to address global unmet demand for trade financing, as a result of balance sheet constraints and limitations in risk appetite. Supply chain disruptions, unstable geopolitics and pandemics can further lead to market distortions and the requirement for additional risk capital. There is therefore a clear and compelling need to create an ecosystem and enabling framework to facilitate access to trade finance by advancing the evolution of trade finance as an asset class for alternative investors. These may include asset managers, insurance companies, pension funds and others who seek a risk/return profile that aligns with the character of trade finance portfolios.

Finally, with the phased introduction of the Basel 3 reforms, there is increasing interest in the development of trade finance as an asset class among leading trade finance banks. There is concern about the reduction in the supply of regulatory bank capital to support the trade finance asset class as well as other loan markets. This is in part due to concerns about the removal of the previous treatment that had existed in earlier versions of Basel which reduced the capital weighting of various off balance sheet trade transactions and the limited success of industry players to argue against such changes.

Considering all of the above and the expected growth in world trade, it is anticipated the requirement for trade financing will increase. This has led to concerns that banks will be unable to meet these needs even if there had been no changes to the Basel capital framework. Past resistance to engaging with capital markets players appears to be waning, as bankers increasingly value the option to "originate and distribute" trade finance assets and to participate within more diverse solutions including tranched or tiered deal structures. This shift is fundamental to any success in advancing the evolution of trade finance as an investable asset class.

As a result, greater attention is being given to increase the level of risk transfer and funding of trade finance from banks to alternative lenders and non-traditional sources of capital such as investment funds (both general and specialist) and other forms of institutional investors (insurers, pension funds, etc.) where there may be no shortage of risk capital to invest. However, their requirements may well differ from those of banks and this needs to be addressed.

To date, the development of institutional investor interest has been modest but has occurred in following main ways:

(i) Bilateral participation by a few institutional investors who have the ability and infrastructure (both from a technology and operations perspective) to undertake underwriting such investments.
(ii) Repackaging of illiquid single name risk (esp. supply chain finance) into securities.
(iii) Transaction-linked notes (e.g. HSBC-Allianz programme).
(iv) Invoice discounting facilities in specific markets for short term receivable invoices.
(v) Specialist funds have developed that invest in the trade finance asset class on a dedicated basis – receivables and payables.
(vi) Securitisation programs allowing institutional investors to access trade finance in leveraged or credit-enhanced form, depending on their respective risk appetite. Those include cash securitisations and synthetic securitizations such as Sealane and Trafin and the multi-sponsor program e.g., Trade MAPS.

Each of above structures has its own nuances and have their applicability in specific circumstances; however, considering the nature of trade finance and the scale of financing needed to address the trade finance requirements in deeper sections of value chain, there is a need to develop more inclusive and standardized processes and solutions to seamlessly distribute trade finance to a wide array of investors in an easy and frictionless manner.

Objective of ITFIE Working Group

The above scenario led to the establishment of the Trade Finance Investment Ecosystem (ITFIE) working group at ITFA with a broader remit to look at how best to improve asset and/or risk transfer across a range of market players and wider institutional capital space. This will serve dual objectives of supporting the real economy by making more capital available for trade and provide another avenue for diversification to institutional investors, to whom this asset class has been elusive.

Harmonization, standardization and digitization are the means:

i) to facilitate more efficient asset and/or risk transfer between banks and nonbank investors, and
ii) to promote and encourage broader risk appetite from non-traditional investors though creation of rules/principles that permit convergence between trade finance and liquid fixed income markets.

But we have several incremental steps to take in this direction. The ITFIE group expects to publish a series of consultations, position papers and surveys to support development of such a framework with this paper being the first in the series.

This paper makes an attempt to:

(1) Bring out existing challenges for trade finance as an asset class, and
(2) Act as a basis for a survey of asset managers/institutional investors on the key barriers and enablers for entry into trade finance

However, this paper recognizes that any approach developed would need to reflect the different approaches taken to quality, duration and due diligence by investors. Equally, the requirement of non-bank investors to have ownership rights in the trade finance assets they invest in needs to be addressed by some enablers for e.g., a methodology for rating trade assets is being discussed with one of the major rating agencies by the ITFIE working group.

Notable Characteristics of Trade finance as an asset class – Institutional Investor view

1. Lack of Standardisation

Given the broad suite of trade and working capital products available from banks and the bespoke nature of trade transactions, it has been difficult to achieve standardisation of products and associated legal documentation. Capital market investors seek to have standardisation of definitions, nomenclature, procedures and a comparison of various investment alternatives against each other, as these aid with transparency and assessment of underlying risks.

How these investors assess risk and their requirements for another party to conduct due diligence and check eligibility of underlying assets can cause problems and needs to be addressed.

The current set of distribution processes are inherently inefficient and problematic (of course for various justified reasons) and the execution timeframe and current modes of distribution are not attractive enough for the alternative investors.

i. Investors are not yet familiar with the asset class and need to get comfortable with the product nomenclature and the risk distribution. However, investors will always have an information disadvantage against banks thus will seek to be safeguarded. Banks have bridged both issues when distributing all other types of assets, from mortgages to credit cards and corporate loans. This will need to be dealt with for trade finance as well.

ii. Transparency of information is the starting point so both seller and buyer are on equal footing. e.g., investors need to be covered against fraud risks as they cannot apply the same transaction checks as banks nor will they have access to the various parties in a transaction. Investors seek scalability and repetition of investments, which requires standardization of sale-purchase agreements, as well as information and data formats. This is commented on further below.

2. Legal and Regulatory Landscape

Given the cross-border nature of trade finance, it is often necessary to consider multiple jurisdictions for a single transaction (e.g., jurisdiction of the counterparties, jurisdiction of any applicable third parties such as obligors in an A/R discounting transaction, governing law of the asset and nature of the asset and jurisdiction of the asset for enforcement purposes). This often necessitates an expensive and time-consuming consultation with external counsel to answer a set of questions that likely has significant commonality and repeatability for many participants. While this will be successful in answering questions in the specific context, it does not always provide any overarching view of how this would compare to other jurisdictional scenarios, and thus any similarities/ differences. Without this context, it is then much more challenging to build any kind of transactional model, given that such modelling itself depends on collating the relevant information and synthesizing it into a more structured form of knowledge.

3. Lack of Market Infrastructure / Industry Standard Practices

Trade finance has been a forte of banks historically and therefore the infrastructure and structures in trade finance largely are bank-led. As trade-related capital market transactions and structures evolve and achieve scale, we expect the next stage of this evolution to be led by the development of platforms and structures where trade-based assets can be placed by sellers for buyers to purchase with standardised procedures / nomenclature, and can thereafter be managed and monitored for the duration of the asset lifecycle. These have to reflect the different position(s) of this class of investors.

For bond markets many marketplaces have been created, without a single platform emerging as the standard. For trade finance a similar set of platforms have to be developed which can address the complexity and nuances of trade finance across the full spectrum of trade finance asset types and structures.

4. Speaking the Same Language

It is clear even at the earliest stage of a dialogue on this topic, that a systematic approach to awareness-raising and education are required, targeting both trade financiers and asset managers. Banks need to learn to speak the language of capital markets, and asset / investment managers must understand the products and terms used in trade finance. This will enable not only enable of investments in the asset class but also help institutional investors in benchmarking trade finance vis-a-vis other asset classes in a consistent manner.

This will mean reflecting the different approach that banks would have to take. For example, in standard transactions banks would require the counterparty to assess the risk. This class of investor cannot do this.

In addition, investors want to see their funds permanently invested and not repaid when a short-term asset is repaid. Dealing with reinvestment mechanisms becomes important as well as a widespread and consistent set of eligibility requirements. Equally, keeping some form of liquidity where funds are involved to cover redemptions is another complication which may need to be addressed.

5. Supporting Sustainable Trade Finance

Trade finance offers a very strong opportunity to direct finance for the sustainable transition of global value chains. The transactional, real economy and transparent nature of this asset class makes it an extremely attractive avenue to direct ESG capital. There is a need to make this possible and unlock institutional capital by making trade finance understood with accessible formats available more widely. As the definitions for sustainable trade finance get developed by the industry, making this accessible using standardized formats and enabling capital flow would be the key challenge.

6. Reputation of the Trade Finance Asset Class

Trade is widely regarded as a very safe asset class due its inherent real economy nature, end use visibility and controls. Its critical to ensure this is well understood by institutional investors by having enough safeguards and mechanisms provided to investors (through a combination of standardized processes, technology and operational tools) to identify and invest in well-structured, ethically conducted trade and trade finance.

7. Other Barriers to Entry

We need to understand both (1) the key risks in trade finance that may currently be acting as a barrier to entry and (2) the key operational and other factors that may similarly be acting as barriers to entry. This will then provide fertile ground for developing and applying a host of technological and operational solutions to make trade finance a fundamentally simpler proposition. Risks, and their potential means of mitigation may include:

- Fraud Risk – transactional controls
- Double Selling/financing Risk – due diligence and transaction risk management
- Eligibility & Operational Risk – operational intensity
- Risk/Reward mismatch – not benchmarked but relationship pricing
- Recovery and loss mitigation – measures and protocols

Possible Solutions

We could address the challenges using a 3-pronged approach

1) By developing Uniform Principles of Distribution and Market Practices

There is a need for creation of common principles covering interests of banks, non-banks and other stakeholders. This could include a different, multi-faceted, approach to documentation and structures for the transfer of assets and/or risks and should aim to include the digitization aspects that can be the catalyst for a more efficient execution of distribution. This could be done by a collaborative approach between existing industry bodies such as ICC, ITFA and BAFT.

In addition to principles, there is need to address the issue around data, how information is made available and who can rely on such data, coupled with the development and implementation of appropriate technology solutions to facilitate the consensus position.

Banks currently have to provide data to various regulators on details of their clients and assets as prescribed by guidelines. There needs to be an enabling framework developed in consultation with regulators for banks to make relevant data available to investors/ participating institutions, just like when banks provide monthly data to holders of ABS paper. This could unlock a lot of capital as it would create transparency and, over time, can help investors to analyse and understand the risk so they can make investment decisions. Here again, there is the need to leverage existing industry frameworks such as the ICC Trade Register to enhance data collection models for trade finance.

Creating a common nomenclature, definitions and listing of key principles of distribution would go a long way in developing the market. This would aid in creating a better understanding of trade products and structures amongst non-bank players.

As a further step, creation of benchmarks and common procedures for investing in sustainable trade finance to leverage the transactional and clear end use visibility that exists in trade finance is a key requirement for channeling capital to sustainable trade.

Coupled with this is the need for documentation which reflects the different approaches investors have to take on what is required from the seller. The documentation should address various stages of trade finance transactions (see figure 2) and reflect the key risk, mitigants and controls to address the challenges of institutional investors, including access formats. This could be in collaboration with BAFT which has previously developed industry standard documents for participations.

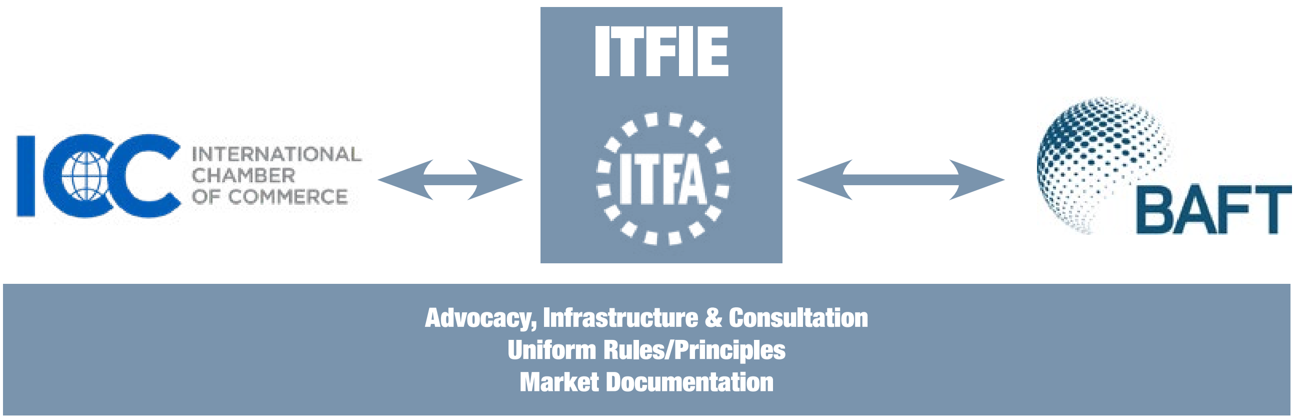


Figure 1. Illustrative model amongst industry bodies

Benefits of having Uniform Principles and Market Documentation

- Help aid development of replicable formats and structures which would enable greater capital flows.
- Help create greater understanding and provide more comfort to non-bank players and new investors to support trade financing.
- Create standardised procedures and formats to promote digitisation of trade for wider investor community.
- Market development and industry standard principles to follow for sustainable trade finance distribution and direct more capital for building back better.
- Reduce friction in transactional distribution and over a period of time creating more cost-efficient model of getting institutional investors into trade finance.
- More efficient methods of distribution will take away the operational barriers and will improve the churn of liquidity.
- Increase number of investors and available funding for trade finance by creating easier access and investment formats.

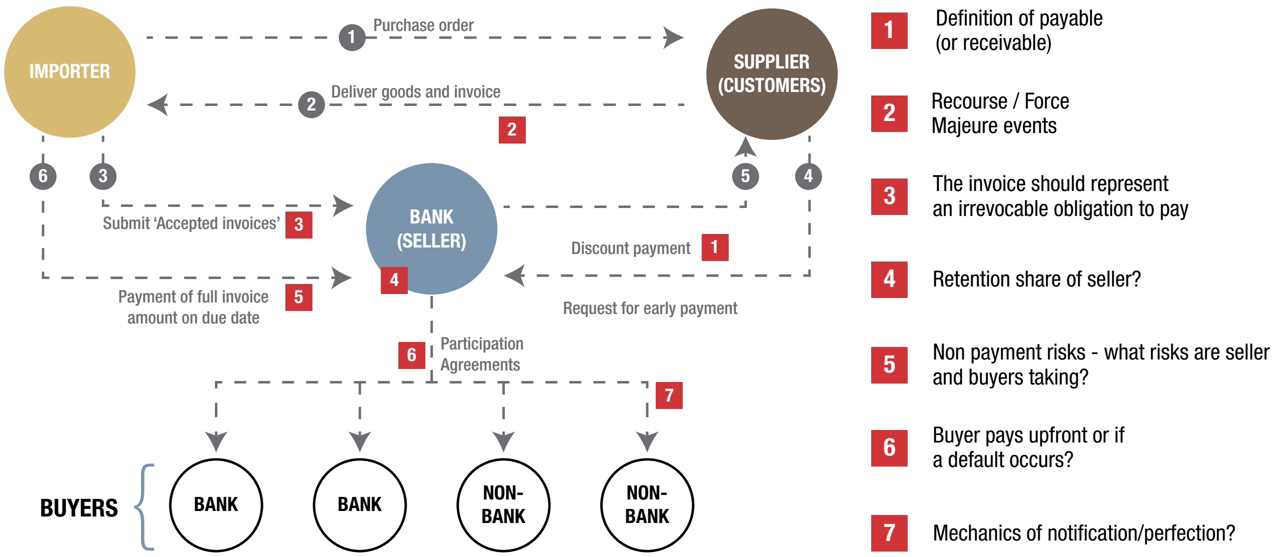


Figure 2. Illustrative example of flow of a trade transaction with some key critical points to address

2) Role of technology

Technology has a key role in unblocking the widespread distribution of trade finance as an asset class by providing reliable technological infrastructure to allow institutional investors to access trade finance portfolios and providing standardised reporting and risk management capabilities to improve risk transparency.

Banks expect technology to increase the level of automation of trade finance distribution. As banks start distributing open account transactions (e.g., corporate risk such as unconfirmed receivables and approved payables), transaction volumes surge and this is where technology brings business critical value. Trade finance is generally a low risk, but operationally intense, asset class. Reducing the transactional friction costs through automation can therefore be decisive for the distribution of short-term assets. The technology stack of such infrastructure needs to allow for straight-through processing.

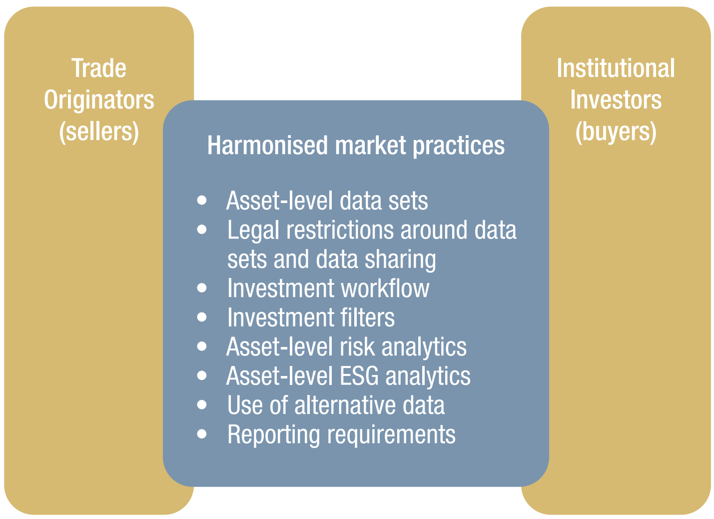
Institutional investors on the other hand also expect technology to bring increased levels of risk transparency on available trade assets. Trade finance is largely unrated and therefore is harder to assess for most non-bank financial investors given their need to satisfy internal and external reporting requirements. Credit risk analytics can be induced from transactional data history and enriched with corporate information to fulfil relevant reporting requirements. Although trade finance can be subject to fraud, dilution, market and in some cases also performance risk, its complexity remains comparable to other commercial bank risks. Investment policies are also becoming more stringent about other restrictions such as the incorporation of ESG criteria.

Institutional investors therefore require access to an appropriate set of data to fulfil all their investment requirements. This in turn requires selling banks to provide the necessary transparency that allows for the preparation of the investor analytics on demand. It must be stressed that investors vary largely with regards to their requirements depending on their industry and country association as well as the precise investment mandate they are subject to.

Some niche investors are seeing value in market inefficiencies and expect to find returns above the risk commensurate level in a trade finance market which is difficult to access for most other institutional investors. Distribution scale can however only be achieved through automation and standardization of both the workflow processes and the analytics.

By automating processes, trade originators will naturally harmonise market practices in trade distribution which will help both sellers and buyers of assets to reduce – and remove where possible – major frictions as outlined on below chart:

Automated processes introduce harmonised market practices



For banks and institutional investors to establish new partnerships, technology helps reduce - and remove where possible - major frictions.

Priorities are on:

- The definition of the minimum (and typical), data sets that investors expect
- The evolution of data sharing practices, and applicable restrictions, around obligor-level and asset-level data sets
- The definition of the asset-level investment workflow including match-making criteria's
- The definition of asset-level risk and ESG analytics
- The role of alternative data sets, and applicable restrictions

ITFIE Automation & Digitisation workstream

Figure 3. Illustrative role of technology in developing trade as asset class

Technology can also address the various risks such as:

- **Fraud Risk** could be mitigated by the adoption of a blockchain-based digital asset servicing solution that uses a consensus model to provide comfort that assets are “real”, i.e., rather than just linking through to the underlying ERP system of the entity generating the asset, it would allow/require confirmation of the existence and terms of that asset from other relevant counterparties (e.g., supplier/buyer in the case of an invoice/receivable).
- Having the assets stored and transacted in a digitized way would allow a more comprehensive register of transactions to be tracked (with appropriate private permissioning and other security/confidentiality features) such that **Double Selling/ Financing Risk** could be significantly mitigated. This could also accommodate, e.g., any filing requirements to make relevant legal transfer/perfection requirements more efficient at the same time.
- **Eligibility Risk** – whether testing the asset against internal parameters (e.g., concentration limits, credit limits, investment mandates, etc.) or external parameters (e.g., insurance policy eligibility requirements), appropriate technology solutions could remove a massive amount of uncertainty, risk and manual operations.
- A technology solution that allows a diverse group of assets to be pooled, but nonetheless allows for tracking down to the individual asset level and sorted it into sub-pools (whether for transacting, distribution or reporting purposes) would make large scale portfolio deals (whether in the primary market or secondary market) significantly easier to achieve in practice, without the additional costs and overhead of a full securitization.

- KYC tools to simplify and make easily available for the funds to adopt to their own KYC requirements
- Provide fund managers with reporting tools to cover the reporting risk and allowing them to monitor their investments relative to their own bylaws.

3) Developing a "Legal Directory"

We believe that a key step in solving the legal complexity of trade finance transactions is to collate a "Legal Directory" that, for the relevant trade finance assets/transactions, collates answers to a key set of questions covering, e.g., enforceability (including with respect to electronic transactions/click-throughs), transfer requirements and mechanics, perfection requirements, regulatory/licensing requirements, etc. This then clearly highlights significant opportunities for simplification and innovation. As just one simple example, when transferring receivables many jurisdictions require notification to the underlying obligor as the perfection method (vs. a central filing method like the UCC or PPSA). It would be relatively simple from a technology perspective to build a solution hosting a "library" of obligor notification requirements such that, when a receivable is sold through an electronic transaction, the system generates the applicable form of obligor notification and delivers this to the right participant(s).

The legal directory can act as a know how guide on various terminologies and practices relevant for trade finance asset distribution and participations. The first step in the Legal Directory process would be to agree on the relevant set of questions as a framework, which could heavily leverage the types of jurisdictional due diligence exercises that many banks and other participants are currently already carrying out in isolation.

Illustrative list of Legal Directory (not exhaustive)

Definitional Items
- Definition of a "receivable" and a "payable" in the trade finance context (and taking into account local law)
- Definition to cover "seller" and "buyer" in underlying transaction vs. "seller" and "buyer" in risk transfer structures
- Definition (and variations) of non-payment (and other) risks for primary and secondary market transaction structures, and which party(ies) bear those risks
- Defining (and variations of) concentration risk in relevant structures
- Definition and explanation of structures involving buyer irrevocable payment obligations and other variations on recourse structure

Legal/Regulatory Diligence
- Legal documentation choice of law and enforceability
- Jurisdictional-specific requirements for execution and registration of documents (including electronic execution)
- Legal transfer/assignability and perfection requirements (filings, notifications, etc.)
- Requirements and mechanics for notification to underlying buyer (e.g., upfront vs. deferred, pre- or post-sale, etc.)
- Applicable currency controls or restrictions
- Applicable regulatory or licensing requirements for purchasing assets / participating in relevant structures

Legal "Market Practice"
- Customary eligibility criteria for the receivables or other trade finance assets
- Customary seller / bank seller representations and covenants
- Typical retention share for seller (which may vary depending on the type of underlying trade finance transaction)
- Customary market approach to applicable perfection requirements

Conclusion/Way forward

Trade as an asset class offers a significant opportunity for both making significant capital available for real economy growth and offering uncorrelated positive yield to institutional investors while ensuring safe and sustainable growth of global value chains. In order to achieve this, there is need for us to address some key challenges around:

1) Developing standardized industry practices, nomenclature and formats.

2) Creating digital and transparent access and operational infrastructure for investors in trade finance.

3) Leverage both of the above for growing sustainable value chains

As part of our consultation in developing the above, we welcome your views and feedback on the need, form and content of industry principles that are needed and highlight key asks from the institutional investor's standpoint. This feedback would act as guiding principles for ITFIE work-streams focused on defining business requirements, developing uniform rules, technology and data principles and industry advocacy focused on developing trade as an asset class.

Appendix

1. Uniform principles for trade finance distribution (not exhaustive)

The Rules should have

- Definitions of different types of trade assets
- Obligations of seller of risk
- Obligations of buyer of risk
- Whether the risk is funded (i.e. buyer of risk pays upfront) or unfunded (i.e. Buyer of risk pays if a default occurs)
- Provisions regarding who takes what risk
- Payment over of receipts
- Recourse parties at commercial Seller and Buyer level
- Recourse events?
- Notification requirements
- Force Majeure
- Fraud risk
- Any electronic records issues
- Governing law of risk transfer transaction

This consultation paper has been produced by ITFA Trade Finance Investment Ecosystem (ITFIE) Working Group.

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