ITFA – The Voice of Institutional Investors

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Global trade is on a long-term growth trajectory driven by mega trends of rising prosperity and population. However, the much-discussed gap between requirements for financing of trade and the available supply of capital is growing at a faster pace, accelerated by factors such as new forms and venues of trade, changing financial regulation, and inflationary tailwinds.

Despite many years of discussion, industry working groups and technological advances, no scalable solution has yet been found to bridge what is potentially a large opportunity to make more capital accessible to finance growing trade. In this paper we will look at some of the routes to non-bank capital sources and examine what we believe is the pivotal role that can be played by the asset management industry in translating the requirements of trade and sustainable growth into the language of institutional investment.

The story so far

Trade finance is one of the oldest forms of banking activity and has been dominated by commercial financial institutions for centuries. Regulation, technology, and the increasing reach of private credit has now started to allow other players to take an active role in it. Indeed, with current regulation and the impending 'Basel end game' implementation, some banks may not alone be able to keep up with global demand for the financing of trade. In parallel, over the course of the last 10 years, a number of specialised trade finance funds have appeared. Initially focussed on a relatively high return corner of the market, and sometimes investing in a broad range of complex cross border transactions, there were quite limited inroads into traditional institutional investment allocations. Banks and other industry participants have made good progress on mapping and explaining the landscape of broader trade finance, but much of it continues to be less appealing to investors either because of esoteric risk drivers, lack of data transparency and/or low pricing.

Working capital finance (receivables and payables) is the first sub asset class of trade finance to find wider recognition and adoption amongst instructional investors. The nature of the cashflows closely resembles traditional fixed income assets, and it is at least superficially more straightforward to assess credit risk than for more complex trade finance loans whose risk drivers may change in nature as the goods physically move from one place to another. It can also potentially be sourced at more attractive pricing levels, either directly from corporates or through non-bank and private credit originators. The traditional banked business where trade finance is often competitively priced as part of an overall corporate banking relationship often does not align with where investors see the price of risk. As such, a number of globally recognized international asset managers have now raised direct lending working capital finance funds and investor interest is rapidly growing.

Appeal to investors

The characteristics of working capital finance could appeal to a number of different investor categories, but also may fit well within the current market environment. An investment strategy with short tenors, stable income, and which is relatively defensive on credit risk can appeal as an alternative to traditional credit investors, but also as a semi-liquid addition to a strategic asset allocation sitting on the liquidity ladder between cash-type solutions and longer dated bonds. Limited correlations to public investment strategies and a large addressable marketplace broadens the appeal for large investors looking to make substantial allocations (of both time and money). The short duration nature of the asset class potentially provides functional liquidity as the portfolios roll over and can also lead to efficiencies in capital required to be held against the assets. Lastly, the short tenors and relatively predicable cashflows can lend themselves to efficient hedging strategies into an investor's preferred currency - certainly something which is far more challenging to achieve on other longer, illiquid forms of private credit.

Investor education and market outreach

Having now been picked up by several large international managers, the asset class has been better defined within the language of institutional investment, robust and transparent investment processes developed, and increased attention paid to areas of legal and compliance. Further steps have also been taken in areas such as ESG risk analysis. As a result, the last 3 years has seen the asset class begin to turn the page from being a relatively esoteric alternative to now being recognised as an increasing mainstream vertical in the broader private asset finance offering, itself currently an area of significant growth. Adopted quite significantly already by European and Asian Insurance investors, there are also signs of growing interest from global Pension funds, Corporate Treasury, Sovereign Wealth, and traditional Wealth Clients. Interestingly, as many banks reduce lending against receivable assets, some funds have also found interest with Bank Treasury investors, specifically if they can be offered as senior facilities.

Access mechanisms

Whilst the highly diversified, granular nature of invoice finance may be appealing to investors, most may not want to bear the operational complexity of having the assets directly on balance sheet.

Broadly speaking two formats have found favour as the preferred routes to access the risk: private securitization and funds, often with a mix of both where investment funds hold a portfolio of notes, each backed by revolving pools of invoices.

The technology behind both mechanisms is well understood by a range of investors, and the ability of asset managers to structure and deliver the notes in different formats to fit the varied requirements of large institutions (inter alia regulatory capital and accounting treatment, booking etc.) has helped large investors in the adoption of the asset class and to broaden appeal to multiple investor types/geographies. Even sophisticated investors may however lack the in-house resources to be able to assess, monitor, and control operational risk in these structures and this is another area where asset managers can offer close oversight and comfort to end clients.

Lastly, whilst achieving public ratings for investments is by no means necessary for all investors and having an independent risk assessment from a manager may often suffice, certain large investor groups will need 3rd party ratings to invest. Working together with Rating Agencies to provide the correct data and investment structures to support investment grade ratings is another area where managers can provide continued support to clients.

Next steps

As investor interest grows the industry must continue to support transparency and education, but if sufficient capital is to be mobilized to meet the growing demands of trade, it must now also broaden the arenas of discussion from highly focussed trade finance conferences to Asset Backed Securities, Private Credit, and investor-specific strategic asset allocation forums.

The financial institutions leading the Trade Finance Industry have the opportunity to access larger pools of capital if they can better meet the demands their customers and institutional investors at the same time. Firstly, rather than simply looking to distribute risk, banks could take a more leading role in the servicing of the underlying programmes in their books and facilitate this to intermediating investment managers. Secondly, they could enhance data sharing from their KYC and AML processes with institutional investors, therefore building trust in the overall trade flows they are financing. Lastly, they will need to share more standardized underlying data of the facilities (name of underlying obligors, address, Tax code, etc.), in order for investors to take an educated decision and be able to comply with their regulatory requirements (e.g. ESMA or Solvency II reporting guidelines).

For the Trade Finance industry, which still largely operates using paperwork, the adoption of digitization is also a significant area of focus. There have been steps taken in regulation (UK Electronic Trade Documents Act), many firms have moved to digital invoicing, and multiple countries have adopted centralized invoice registration. Trade receivables may also be an area that lends itself better than other forms of Private Credit to tokenization, and various proof of concept projects have already been carried out both by banks and asset managers. Lastly, AI is being adopted rapidly to assist in initial underwriting and credit assessment, plus in pattern recognition for ongoing risk monitoring.

Indeed receivables finance is a particularly interesting area of illiquid credit because of the ability of managers to gather significant amounts of data to support such models. Together these advances will incrementally improve investment performance, address key operational risk areas such as fraud prevention, improve investor confidence, and in turn spur interest from more allocators of capital.

About ITFIE

This paper is a publication of the ITFIE Working Group.

The ITFA Trade Finance Investment Ecosystem (ITFIE) Working Group strives to enhance the trade finance investment ecosystem by facilitating more efficient asset and risk transfer between banks and non-bank investors, while promoting broader risk appetite from non-traditional investors.

By harmonising, standardising and digitising processes, ITFIE aims to support the real economy by increasing capital availability for trade and offering institutional investors a diversified asset class.

ITFA has been at the forefront of this initiative since 2021, when it took over the International Chamber of Commerce-led Investors in Trade Finance (IITF) Group.

ITFIE's work streams strives to achieve several objectives, including articulating the requirements of institutional investors and ensuring a clear understanding of the technical aspects of distribution; developing an asset originator guide for streamlined distribution; driving automation and digitisation for trade finance distribution; and promoting market awareness and education for both, asset originators, and investors.

ITFIES is constructed under three work main streams:

Stream A: Voice of the Institutional Investors

Stream B: Rules of the Game

Stream C: Technology and Data

This paper, a first of others to come, will be jointly published as part of ITFIE´s findings and conclusions from its three Work Streams at a later day.

For additional information on ITFIE´s activities please do not hesitate to access:

https://itfa.org/about-us/working-groups/itfie/

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