# Trade funds: Understand your risk buckets better

*Getting banks, regulators and investors to understand trade funds better is key to trade evolving as an investible asset class. Aidan Applegarth, owner and managing director of Bankingwise, a trade services consultancy is perturbed by the lack of support from the banks and the fact that the market has potential to grow as long as it's not viewed as one-size-fits-all.*

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**TXF: Paint me a picture of the state of the market – what are trade assets in actuality? Who are the old players and the new ones?**

**Aidan Applegarth (AA):** Interesting question. In terms of the evolution, there have been trade funds around for quite a while now, even before the turn of the millennium. While in the past a lot of trade funds may buy assets from banks, nowadays a lot are looking to intermediate to fill the gaps the banks have left.

We have to define what we mean by trade funds to answer the question about assets as different players are looking at different aspects of trade as the asset. If you look at the trade products, not all are investible. For example, if you look at the ICC Trade Register and look at the products there, to be investible you need transparency, ideally asset-backed. You need to have some self-liquidating component. A number of those products, import LCs for example, are they investible? Probably unlikely. On the other hand, you look at export LCs (particularly confirmed export LCs) and payment guarantees which seem to be among the most popular investible asset classes.

You then have investors who see an appetite to have that kind of asset behind them. What's changing, the evolution in the last few years, is that because of the so-called trade finance funding gap, particularly in the SME space, you now have a plethora of new funds emerging who are looking to plug that gap.

So, in fact, they are looking at loans, usually asset-backed, usually self-liquidating, ideally relatively short-term tenors that will get a bit of a churn. They are specifically targeting a market, which because of the banks being burdened by regulation, banks are no longer able to support and fulfil.

If you look at a number of funds that have come out in the last 12-18 months, a key criteria for them is to say they are targeting this SME space, targeting commodities, targeting trade flows which the banks are today not able to support.

**TXF: Interesting. You are talking about trade assets as an investible class. I've heard comments saying "trade assets don't exist as an investible asset class unless you can see them on a Bloomberg screen". Where are we at with that?**

**AA:** What is Bloomberg looking at for a start? It's covering very well established defined markets. It's clear that trade finance as an asset class is in its infancy. It's going to take a while for it to get to a point where it registers as [something that appears on] Bloomberg, but I think one day it will.

My reasons for saying that is that in the past, if you look at how trade finance was positioned by various banks, it was invariably part of a general corporate banking portfolio. You couldn't really distinguish your trade finance assets from your corporate loan assets. In fact, it's only really since the 2007 crisis banks have started to gather information in a very discrete, defined way to say 'this is our trade book' and 'this is our corporate book', so you've never really had that separation.

Now that that opportunity exists, the data exists. The ICC through their excellent Trade Register report have started to provide information which people can start to use and leverage from.

I have a bit of a bugbear about that as I do still see quite a number of emerging funds saying this is a low-risk/ almost no-risk product because it's only 0.02% default, which is the rate that the ICC shows across those trade products, but of course a lot of these funds aren't offering those products per se, they're offering loans. At the moment, apart from the import and export loans, the ICC has not yet been able to capture, for example, default rates for receivables finance for borrowing base or for commodity trade loans.

The nearest thing for commodity trade loans comes from a survey I was actively involved in in 2015, getting a core of commodity banks together when we were challenging back on Basel regulation, particularly around CRD IV [Capital Requirements Directive IV] and the inability to apply or, let's say, the closure of the internal low risk default models. That to me has been on the one hand a disaster from a regulatory perspective. The unintended consequences are that banks may over time leave this secure commodity space altogether because they won't be able to get the benefits of collateral. And that has been pushing people like myself and other former commodity trade bankers to set up funds and to say 'we know what we're doing - the regulators may not have taken the opportunity to look at how these low default rates are arrived at and therefore we have an opportunity to push this market away from the regulatory constraint.'

But I do insist there needs to be a better mapping of what are the real defaults. It's not 0.02%, it's more likely around 0.8% for commodity trade loans, which still compares very favourably with for example, Standard & Poor's.

So from a Bloomberg perspective – they will start picking up on trade funds once we see that investor growth behind it, once the chatter around trade funds becomes more positive and when the banks start buying in and supporting [them]. For the moment they are standing back from even supporting the funds. A lot of that is a lack of understanding. With a bit of education and better construct around the funds, yes one day Bloomberg will start supporting trade finance assets.

**TXF: Just winding back slightly, banks want to offload trade assets from their balance sheets, given Basel III – who, apart from other banks, actually wants to buy them?**

**AA:** There are investors out there. They may be institutional investors, pensions funds and others who are looking for trade finance assets as a part of a balanced portfolio. The survey that TXF had done with EFA earlier in the year [https://www.txfnews.com/News/Article/6369/Get-the-full-report-Trade-finance-faster-food-for-fund-appetites] had highlighted that there were indeed those investors who felt that they had a sufficient understanding of trade finance that they would take on certain assets and no doubt with certain parties that they could depend on. So they would come into a bank they liked, or one they knew that could originate and that could understand the business.

Whether those same investors will start coming into some of the newly emerging funds to take on assets remains to be seen. As the chatter does increase around trade finance as assets we will see perhaps more funds dipping their toes in the water, maybe not big amounts to start off with but certainly coming in and testing out this market.

If you are managing an investment portfolio, you're looking to have that blend of good high yielding assets, some stability and something relatively safe, trade finance meets that criteria. I've seen comments where people have said it's no risk, well it's never no risk. But it is low risk.

The caveat I would say is that it's low risk if the parties managing those funds, particularly managing the deployment of those funds into the loans, know what they are doing. And that's the real differentiator.

If I had one concern about the segment it's that there will be people coming into the business as they see it as an opportunity but they won't have the pedigree and experience behind it to run it properly. If those people are in the position where they screw up on the delivery of funds, that's going to harm the establishment of trade finance as an asset class going forward. It makes a difference who's involved, who's underpinning this and do they have the people who can go around and kick the tyres and really chase these things up when needed.

**TXF: How do the newly emerging alternative debt funds go about getting banks to take them seriously?**

**AA:** With difficulty. I know that from experience. There are very few banks today that will take onboard any of the trade funds. Why do the trade funds need the banks? Because they need a party that can execute on their behalf. What the trade funds will be good at will be originating investors and in many cases originating deals.

Having spoken to a number of key banks represented in the ICC Banking Commission, despite the ICC Banking Commission looking to promote trade finance assets, I see a conflict. Parties involved are not really engaged in understanding what are the issues around the funds. They are a bit too blinkered by saying 'Oh, the funds, that means they'll be getting drug money in, or passing funds through, they won't know the provenance of the funds, there's no transparency or regulation…' Not at all true.

If you look at the funds that have been set up here in the UK, they are regulated by the FCA and through the Alternative Investment Fund Managers' Directive. So there is regulation. A lot of these parties are investing heavily in appropriate management due diligence systems using World-Check, using Bureau Van Dijk and other parties who offer these kind of services.

They know full well, as many of them are former bankers, that the success of them as a fund depends on them being able to deploy in a systematic and diligent way to ensure that they get money coming through. In order to do that they don't want to get caught by sanctions, and in a very dollar denominated business they don't want dollars being held up by the Fed [US Federal Reserve] because a party to a transaction was caught on an AML [anti-money laundering], financial crime or sanctions list.

Some of these funds are probably even more diligent than the banks in that regard and they do it because they are entrepreneurs and it's their business [that they want to succeed]. Today I'm disappointed in the response I'm getting from banks to supporting funds. There's only one bank I know, overseas, that will support. But for the mainstream I think they need to get their act together because there is room for collaboration here. These funds aren't treading on banks' toes because banks have already rejected this segment of the market as it's too cumbersome for them.

The banks have an opportunity here, in many cases cash-covered, to be able to take funds in, to support issuance of letters of credit (LC), guarantees etc. they can handle the treasury flows. I think there's a win-win for both parties involved if they can take the time and [for banks to] sit down and understand what it is these funds are all about.

**TXF: You mention banks, to what extent can Fintech providers give support, and what are the next steps for Fintechs?**

**AA:** Fintech is an interesting area now because there are a lot of Fintechs emerging in the financial services space, many of whom can't get into the mainstream banks. Why? Because a lot of these banks are locked into legacy systems or already have their providers and they look for the track record. In some cases it's difficult for some of these emerging Fintech firms to get involved. That's where I think there's a good opportunity for the funds. Where many banks may still use excel spreadsheets to manage commodity portfolios, in this day of compliance, audit reviews and so on, it's not an efficient way of doing that. There are opportunity for Fintech providers to provide those facilities.

This afternoon I'll be seeing a company offering a platform for commodity trade financing where you have the SME borrowers putting in the details of what they want and it goes to a kind of clearing system and due diligence system and then investors can pick what they want to invest in. There are already firms offering KYC [know your client] platforms – World-Check is in with the banks and also with the funds. There are other firms coming at the trade funds aspect from different angles. Many of the trade finance funds are aware they need to be transparent, auditable by investors. When investors come in and do their due diligence they don't really want to have to say 'this is the guy that handles the investors and it's the same guy who deploys loans and does everything else.'

If you are after institutional, pensions fund type investors you need to respect their own due diligence requirements, for division of labour, Chinese walls between funds and back offices, etc. The whole setup of trade finance funds can be enhanced by good Fintech support. That is something that is still evolving and if the parties put their heads together and realise that 'solution A' that was designed for a particular purpose may be overkill for the funds and could be adapted, that would be great.

One of the things I have been looking for is to find software that can blend the fund management aspect with the deployment through loans and collateral management put together rather than this segmented approach.

**TXF: It's always amazed me how low tech the sector's been – you talk about excel spreadsheets, etc. And you say transparency is key, how can price discovery be made better, more transparent than, say, via WhatsApp?**

**AA:** Price discovery is interesting – price discovery for what purpose is the issue. If you are talking about a fund, from an investor's perspective, price discovery is 'what's my return, what's my outlay?'…Having looked at different funds, and how many of those report what their returns are, my advice anyway to investors is it doesn't matter what number you look at, go and understand how that number is achieved.

Because you'll see funds that say 'we can give you 20% return net of fees, net of everything'. How? That sounds high risk to me. It doesn't sound real either.

You have other firms with 7-10% returns. Again, depending on what profile of risk asset you are looking for you have to moderate your aspirations and expectations in terms of return. Just having a number on WhatsApp is nothing unless you know how that number is achieved. Is it because they have to keep their funds rolling up all the time that I have to keep an accumulative return? Is it a genuine net return?...the real crux of the matter is how is it achieved?...

**TXF: Ratings are a thorny issue that could help attract investors – how can that be addressed? Will ratings be attached to specific funds or transactions?**

**AA:** It's a tricky one. Having worked in the sector for many years, particularly in my time at UBS when we were trying to securitise parts of the loan book, it's not so easy. Particularly when you have – as you would in the funds space – loan books which are evolving in their risk profile through the tenor of the loan. You may start off on day one, you're largely unsecured, there may be goods sitting with a freight forwarder somewhere in a port, then they move on board a vessel – you've got a bill of lading, you're more secure. And then maybe as it migrates through that process you've got an inward letter of credit, a confirmed one. So your risk profile is changing all the time. How do you identify the right bucket to put that risk in?

It's a challenge. Perhaps Fintech might solve that problem if they can be sophisticated enough to keep shifting assets in and out of certain classes. The best way I see to do it is to profile a fund to meet a certain risk profile. You may have funds which are fully asset backed with very liquid assets, maybe all exchange traded, etc which could be rated pretty well. And then you look at others which maybe aren't exchange traded commodities, perhaps other products in bulk which may function like a commodity but they aren't hedge-able on an exchange, that's a different class altogether.

Provided people think more in terms of approximated buckets then it's on the road to getting a rating system developed. It should be allowed to evolve and be something that can be tried and tested before it gets bolted down. There are other bodies, such as the ICC, looking to standardise and harmonise this space. It's a demand from investors to find some sort of standardisation. If by that they mean 'we want to know what bucket this risk profile falls in?' then it's a good thing for the industry generally to do.

How then those deploying funds are able to categorically say 'this sits in this bucket' and is not somewhere between, remains to be seen. As a goal, yes it will be a good thing.

**TXF: Basel remains a fly in the ointment for the whole sector – are banks basically going to have to 'suck it up' whatever happens to Basel III/IV?**

**AA:** I think so. The regulation as it stands today is one size fits all in a sector where clearly it's not all one size. Having been involved in the past trying to get the regulators to see things a bit differently, the ICC had some success in that, but it's a very moderate success compared to the unintended consequences of CRD IV and current regulation.

At the moment, the biggest weakness of all is that the regulators have not taken the time to sit down and understand how have those low loss default portfolios been low loss. What are the mechanisms and the activities going on behind the scenes that make that happen? For example, the fact that you have in many cases a double or perhaps triple default before you have any impairment in looking at a lot of commodity trades seems to be beyond them in their understanding. They think that somehow there must be something underhand going on, which isn't the case.

However, having said that, I'm advising the funds that I'm in touch with to start thinking about regulation, because the way things go, as the chatter increases in this space, it's inevitable that at some point, someone's going to turn around and say 'oh look at this unregulated market, shouldn't we do something about it?'

It is regulated in terms of the fund manager by the FCA but not necessarily what's going on in terms of transactions. I wouldn't want to see regulation become the stricture it's become for banks, it's been overkill. Considering it was the virtual economy that screwed things up for everyone, it's now become the real economy that's being hit. Why? Because that's what you can touch and measure. A lot of it has been too much and too late in any event.

Basel is hitting the banks which is creating the opportunity for the funds. I'd like to think that opportunity will continue for the funds before anyone comes in with heavy hands and starts knuckling down and putting some strict frameworks around this.

On the other hand, you look at some bigger institutional investors [who] might be looking for some level of regulation and the real issue is to find that right balance…If regulators can find that blend that says 'this is regulated', investors can take comfort from putting funds into this market, but it's not so strict that everybody's hands are tied in the way the banks are, then that's got to be something that will be a boon for the market overall.

**TXF: In conclusion you're optimistic that this sector will continue to grow?**

**AA:** I am. Why? Because there's a huge demand among SMEs in particular. The SMEs feel in many ways not represented by the banks, perhaps cheated in some ways. They want people that understand their business, perhaps with a similar entrepreneurial approach to it. The trade funds can offer that. They can offer a greater speed and flexibility in terms of putting together the loans/ package and can be more there in an advisory capacity to be able to have that dialogue. They are more liberated in a sense to have open dialogue with the customers from the funds' perspective.

Yes, I do see it growing. The banks worry that nobody wants to be caught by something going through their books in their name where the Fed [US Federal Reserve], in particular, is going to turn around and say 'how did you allow this to happen?' and that somebody is going to lose their US licence. There's going to be that space from a trade-off position [where] it's not worth [the banks] getting into that market, let's leave that to the funds. I'd like the banks then to say 'we understand now more about the funds, we understand there's proper regulation, we understand they aren't cowboys, let's find a way to collaborate.'