Paving the way for trade finance securitisation

By Hans Krohn, 28 January 2014

Hans Krohn, Head of Trade Products at Commerzbank, heralds the bank's success of its CoTrax Finance II-1 trade finance securitisation. But why it has taken so long for this emerging asset class to get off the ground and what will it take for the trade finance securitisation market to succeed in the long-term?

Securitisation of trade finance assets is not new. Yet over the past year we have seen a marked rise in interest in trade finance securitisation deals, with the recent wave of issuance indicating that this asset class may well emerge from the shadows over the next few years. Commerzbank is one of a handful of banks to close such a deal – called CoTrax Finance II-1.The success of the deal shows that trade finance securitisation can attract institutional investors – allowing banks to satisfy capital requirements and at the same time provide institutional investors with access to an emerging asset class. Yet in order for the market to succeed on a larger scale, it still needs to get more investors comfortable.

Certainly, banks have been discussing trade finance securitisation for years – with the world's first rated trade finance securitisation completed in 2006. Yet the market failed to take off. Of course, the crisis of 2008 was an inhibitor, forcing banks and investors to retreat, but there have also been other significant barriers to the market's success. First and foremost, trade-related assets were simply not available to institutional investors in previous years as banks either kept them on their own books or traded them more or less exclusively on the interbank market.

Banks' reticence to issue such securitisations in the capital markets is partly fuelled by investor perception. Certainly, many investors have so far failed to grasp the appeal of the asset class; both in terms of its stability (default rates of trade finance transactions are incredibly low), granularity and in terms of its potential yield. Last but not least, a lack of standardization of documentation underlying trade finance transactions has also deterred investors, especially since the financial crisis.

Some of these barriers are being broken down, however, and last year trade finance securitisation returned, albeit tentatively. Commerzbank is one of the few members of a group of pioneers in this respect – successfully closing the CoTrax Finance II-1 placement in September 2013.

Breaking down the barriers

So what has brought about the wave of issuance witnessed in the last quarter of 2013? First of all, global trade has been picking up, resulting in dramatic, exponential growth in trade finance in recent years. At the same time, however, there are few new financial institutions entering the market to meet the growing demand, and existing players are facing unprecedented regulatory hurdles requiring them to hold more capital against trade finance loans. For this reason, banks are striving to come up with structures that help them to reduce risk-weighted assets and hence core capital requirements.

One way of doing that is by attracting institutional investors through securitisation of lending assets. This way, banks offload the credit risk to a third-party investor and, at the same time, ease potential pressure on their own balance sheets brought about by capital adequacy constraints (due to Basel III as well as local regulations). As a result, a window of opportunity was opened for trade finance assets to become packaged for institutional investors who, in the current low-interest rate environment, are more amenable to investing in what they now recognize as a low-risk asset class.

Certainly, these investors have woken up to the fact that trade finance assets are different to any other asset class. Trade finance securitisation was something many investors had not considered until the International Chamber of Commerce and the Asian Development Bank set up a Trade Register in 2006, detailing trade finance transactions. At the end of last year, the number of banks delivering trade data into the register increased to 20. The register shows very low default rates of trade finance assets compared to corporate loans. Indeed, the data points to a probability of default of around 0.02% with fewer than 1,800 out of almost 8.1 million short-term trade finance transactions defaulting between 2008 and 2011. Furthermore, the likelihood of default is consistently low across all products – letters of credit, loans and bank guarantees – with transaction default rates of 0.035% or less for all.

CoTrax as an example of success in the market

Commerzbank – as a leading trade financier – is determined to be at the forefront of the securitisation trend. With CoTrax Finance II-1, the bank sought to attract investment in its trade finance assets with a view to creating a pipeline of trade securitisations. The vehicle was a US$500 million portfolio of short term trade-related financings with banks, which was securitized, with US$22 million of a US$27 million mezzanine tranche placed with institutional investors. The deal's success was, of course, reliant on it being structured in a way that was stable and met with the approval of the regulators. But success was also dependent on getting investors comfortable with the risk.

In order to achieve this, portfolio diversity and granularity was crucial. Given that Commerzbank is active globally, investors wanted to see deals from all over the world. Indeed, country exposure, bank exposure, and counterparty exposure were all important criteria in defining this reference pool. The CoTrax reference pool upon issuance was made up of around 160 transactions (of around 80 debtors) with an average probability of default of 0.99% at the outset. This consisted exclusively of short-term trade-related financings with other banks, from a wide range of domiciles (23% of the deals came from Brazil, 22% from China, 12% Panama and 7% Russia, with the rest spread across 12 different countries).

The second key factor behind the success of the CoTrax deal was its division into tranches. The pool of assets was separated into a senior tranche, which Commerzbank kept, and a US$27 million mezzanine tranche; US$22 million of which was placed via a private auction. Slicing the deal into tranches is one of the ways of enticing investors given that they are usually accustomed to higher yields than those offered by trade finance. In the case of CoTrax, Commerzbank sold off the high-risk portion, offering attractive yields to investors while still providing security and a low risk of default on the reference pool as a whole. Indeed, the deal was met with a great deal of enthusiasm from investors.

What’s next for trade finance securitisation?

While demand for trade finance securitisation is on the rise, more liquidity needs to be generated and new investors attracted if the market is to thrive in the long-run. For this to be achieved, however, further education and promotion of trade finance’s stable nature is essential.

Certainly, there is still much misunderstanding among investors about the character of trade finance assets – a fact that not only restricts the potential pool of buyers, but also dissuades trade finance originators from issuing securitisations for fear of limited interest at the placement stage. Of course, the onus here is on the banks to continue to liaise with investors, with the success of such deals as CoTrax useful examples of how well-structured securitisations can effectively meet their investment criteria.

Standardization of trade finance documents may also help get investors comfortable with the asset class. Although trade finance transactions are in general well-defined, no two deals are ever supported by the same underlying documentation and contracts. This is something that Commerzbank in particular continues to address by, for example, putting more master agreements in place.

Another way of attracting new investors is to respond to their demand for portfolio diversity by creating an inter-bank securitisation – where a number of banks pool their trade finance assets. As things stand, there are only a handful of banks globally with portfolios big enough to cope with investors’ requirements for granularity; most instead have a small number of trade finance counterparts with which they conduct a high volume of business. Yet this introduces concentration risk for investors. The aforementioned idea proposed by the London Group, a think-tank created by industry trade association BAFT-IFSA, therefore helps by creating a larger pool than any individual bank is capable of providing – circumventing a key investor concern.

However, the downside to implementing this structure is that the more banks involved, the more complicated it becomes and the higher the resulting overheads. Nonetheless, this is a structure which works – as shown by the Citi and Santander deal last year – and it is something for financial institutions to consider as a solution to move trade finance assets off-balance sheet.

Commerzbank has a great deal of experience in the field of securitisation, as demonstrated by its large scale SME loan securitisations, which are issued at least once a year and are well-perceived by investors. For this reason, Commerzbank will be one of the banks leading the development of the trade finance securitisation market. Please watch this space.