TRADE FINANCE

Beginners guide to Trade Finance

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Introduction: Meaning and Role of Trade Finance

Trade finance is an indispensable "oil" to make trade happen. Trade Finance exists to finance the trade cycle at various points of transaction, allowing participants to manage the capital required for trade, while mitigating or reducing the risks involved in an international trade deal. Only a fraction of international trade is paid cash-in-advance. For this reason, the trading system needs a well-functioning financial system providing trade loans and guarantees to traders.

Only a small part of international trade is paid ‘cash-in-advance’, as importers generally wish to pay, upon receipt of the merchandise in order to verify its physical integrity on arrival. Exporters, however, wish to be paid upon shipment. In order to bridge the gap between the time at which exporters wish to be paid and the time at which importers will pay, a credit or a guarantee of payment is required. Trade finance provides the credit, payment guarantees and insurance needed to facilitate the payment for the merchandise or service on terms that will satisfy both the exporter and the importer. A key aspect of trade finance is that it helps mitigate the risk of cashless trade transactions.

Trade Finance deals typically involve at least three parties, the exporter (seller), the importer (buyer) and the financier. Trade finance also differs from other types of credit products as transactions should have the following features:

- An underlying supply of a product or service
- A purchase and sales contract
- Shipping and delivery details
- Other required documentation (certificates of origin, etc)
- Insurance cover
- Terms and instruments of payment, e.g. letter of credit, advance payment, deferred payment, etc.

Eco System of Trade Finance

Stakeholders	**Entity/ies**	**Roles and Responsibilities**
Private Entities	Importer, Exporter	Buy and sell goods and / or services across borders
Banking Institutions	Importer’s bank, Exporter’s bank, Correspondent bank	Provide risk mitigation and financing
Government and Government Bodies	Import customs, Export customs	Set the rules and standards
Facilitation Platform/s	Invoicing platform, SWIFT, Freight forwarder, Insurer, Pre-shipment Inspection, Import /Export terminals, Shipper, Document courier	Provide services to support Trade Finance ecosystem
Disruption Platform/s	Artificial Intelligence, Machine Learning, IoT etc	Introduce Tech-enabled solutions to the world of Trade Finance

Trade Finance: Necessity and Benefits

- Trade finance facilitates the growth of a business. Managing cash and working capital are critical to the success of any business. Trade finance is a tool which is used to unlock capital from a company's existing stock or receivables.
- Trade finance allows competitive terms to both suppliers and customers, by reducing payment gaps in the trade cycle. It is beneficial for supply chain relationships and growth.
- Trade finance is a solution for short to medium-term working capital, and uses the underlying products or services being imported/ exported as security/ collateral. It increases the revenue potential of a company, and earlier payments may allow for higher margins.
- Trade finance allows companies to request higher volumes of stock or place larger orders with suppliers, leading to economies of scale and bulk discounts.
- Trade finance can also help strengthen the relationship between buyers and sellers, increasing profit margins.
- It is important to note that trade finance focuses more on the trade than the underlying borrower, i.e. it is not balance sheet led. Therefore, small businesses with weaker balance sheets can use trade finance to trade significantly larger volumes of goods or services and work with stronger end customers.
- Trade finance lending instruments have embedded risk mitigants which may allow a trading company to access a more diverse supplier base. A more diverse supplier network increases competition and efficiency in markets and supply chains.

Stages in Export Finance

Pre-shipment Finance and Post-shipment Finance: The main purpose of pre-shipment finance is to enable exporters to procure raw materials, carry out the manufacturing process, packing and forwarding the finished goods. Pre-shipment credits are granted in the form of packing credit, advances against receivables from the government, like duty drawback etc, advance against cheques /drafts etc which represents advance payment.

Post-shipment finance means any loan or advance granted or any other credit provided by a bank/ financial institution to an exporter of goods / services from India from the date of extending credit after shipment of goods / rendering of services to the realisation of export proceeds. The facility is meant for financing export sales receivables which is self-liquidating in nature, granted up to 100% of the invoice amount and with recourse against the exporter.

The Government of India along with RBI introduced '**interest equalization' scheme.** The 'Interest Equalization Scheme for pre and post-shipment Rupee Export Credit' provides an interest assistance to exporters. Banks provide Interest Equalization Scheme benefit to the eligible exporters and claim a reimbursement of the same from the Reserve Bank of India based on the external auditor certification furnished by the exporter. The scheme helps the identified export sectors to be internationally competitive and to achieve a higher level of export performance.

Risks in Trade Finance

International Trade has particular characteristics that give rise to different types of risks. The following is a selection of some of the key risks in international trade finance:

- **Country Risk:** A collection of risks associated with doing business with counterparties based in a foreign country, including exchange rate risk, political risk and ultimately, sovereign risk. Factors to bear in mind when considering country risks involve the current political climate in the country, the state of the local economy, the existence of reliable legal structures, the availability of hard currency liquidity, among other factors

- **Corporate Risk:** These are risks associated with the exporting/importing entities, primarily focusing on their credit rating and any history of defaults, either through non-payment or through non-delivery/deficient delivery.

- **Commercial Risk:** Commercial risks refer to potential losses arising from fragilities stemming from the underlying trade (quality/adequacy of the goods being traded, robustness/adequacy of the contracts, pricing matters, etc).

- **Fraud Risk:** These are risks typically associated with either unknowingly engaging with a fraudulent counterparty, receiving forged documents and insurance scams.

- **Documentary Risk:** Documents play a vital role in international trade. Missing or incorrectly prepared documents pose risk for both buyers and sellers as this can cause delays in shipments and ultimately delays in payments.

- **Foreign Exchange/Currency Risk:** This is the risk posed by fluctuations in the exchange rates, relating to payments and receipts in foreign currency. In certain cases, the exporter or importer may have no control over this movement in the rate of exchange and on occasion such changes can wipe out the profit or even more attributed to the transaction.

- **Transport Risk:** About 80% of the world's major transportation of goods is carried out by sea, which gives rise to a number of risk factors associated with transportation of goods. Storms, collisions, theft, leakage, spoilage, cargo theft, scuttling, piracy, fire and high sea robbery are just some of those risks.

Products of Trade Finance

Trade finance products are generally categorized under two areas: **Unfunded Trade Finance** and **Funded Trade Finance**.

- **Unfunded Trade Finance products** are focused on credit enhancement/support, such that the provider involved does not offer liquidity to the trade counterparts, but rather supports the transaction by guaranteeing the performance of the parties in their different roles.
- **Funded Trade Finance Products** are focused on the provision of funding/liquidity by a financial institution to the parties participating in the trade transaction.

As such, trade finance products focused on risk mitigation help settle the conflicting needs of the parties (normally an exporter and an importer, as far as international trade is concerned). Where an exporter needs to mitigate the payment risk from the importer, it would be in its best interests to accelerate the payment from the importer.

On the importer's side, its aim is to mitigate the supply/performance risk of the exporter and thus receive the goods before it has to effect payment. In these cases, trade finance products effectively function as a mechanism whereby providers absorb the risks inherent to the trade (mostly payment and supply related risks), whilst also potentially providing the exporter with accelerated receivables and the importer with extended credit.

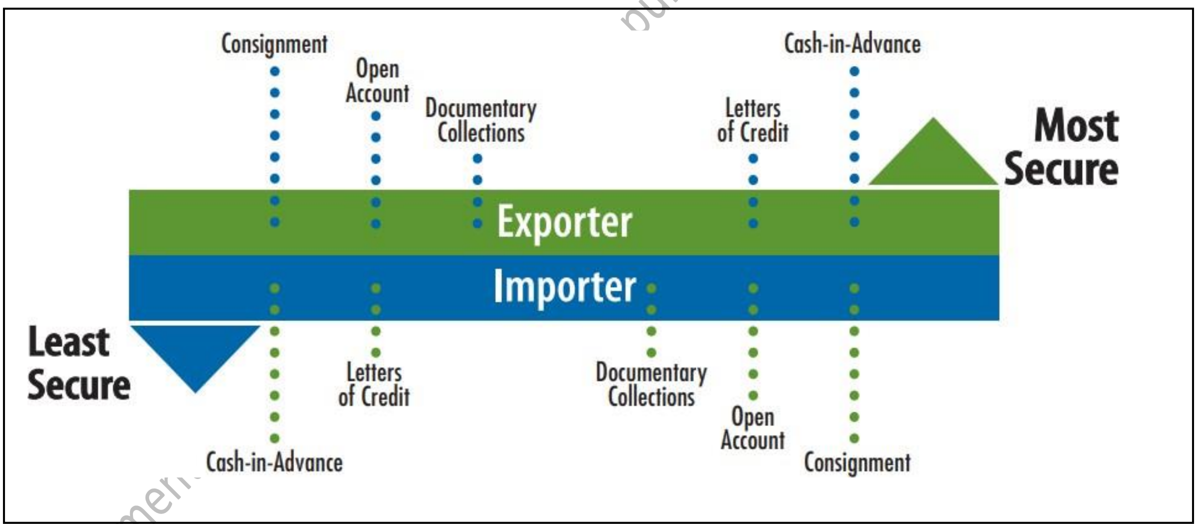


Figure: Payment Risk Diagram[1]

[1] Trade Finance Guide by US Department of Commerce

1. Cash Advances

With the cash-in-advance payment method, the exporter can eliminate credit risk or the risk of non-payment since payment is received prior to the transfer of ownership of the goods. Wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters.

2. Buyer's Credit

Buyer's credit is a financial arrangement whereby a financial institution in the exporting country, or another country, extends a loan to a foreign buyer to finance the purchase of goods and services from the exporting country. This arrangement enables the buyer to make payments due to the supplier through credit arrangement from financial institutions in the supplier's country. Credit risk in realizing the payment falls on the financial institution which may seek cover from Insuring Export Credit Agency (ECA).

3. Supplier's Credit

Supplier's credit is a financing arrangement under which an exporter extends credit to the buyer in the overseas country to finance the purchases of the buyer. Credit risk is to be borne by the supplier who may de-risk by availing cover from ECA.

4. Letters of credit

Letters of credit (LCs) are one of the most versatile and secure instruments available to international traders. An LC is a commitment by a bank on behalf of the importer (foreign buyer) that payment will be made to the beneficiary (exporter) provided that the terms and conditions stated in the LC have been met, as evidenced by the presentation of specified documents. Since LCs are credit instruments, the importer's credit with his bank is used to obtain an LC. The importer pays his bank a fee to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain or if the foreign buyer's credit is unacceptable, but the exporter is satisfied with the creditworthiness of the importer's bank. This method also protects the importer since the documents required to trigger payment provide evidence that goods have been shipped as agreed.

5. Factoring and Forfaiting

Export factoring is a complete financial package that combines export working capital financing, credit protection; foreign accounts receivable bookkeeping, and collection services. A factoring house, or factor, is a bank or a specialised financial firm that performs financing through the purchase of invoices or accounts receivable. Export factoring is offered under an agreement between the factor and exporter, in which the factor purchases the exporter's short-term foreign accounts receivable for cash at a discount from the face value, normally without recourse. The factor also assumes the risk on the ability of the foreign buyer to pay, and handles collections on the receivables. Thus, by virtually eliminating the risk of non-payment by foreign buyers, factoring allows the exporter to offer open account terms, improves liquidity position, and boosts competitiveness in the global marketplace.

Forfaiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount on a "without recourse" basis. A forfaiter is a specialised finance firm or a department in a bank that performs non-recourse export financing through the purchase of medium and long-term trade receivables. Forfaiting eliminates virtually all risk to the exporter, with 100 percent financing of contract value.

6. Documentary Collection

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of payment to the exporter's bank (remitting bank), which sends documents to the importer's bank (collecting bank), along with instructions for payment. Funds are received from the importer and remitted to the exporter through the banks in exchange for those documents. D/Cs involve using a bill of exchange (commonly known as a draft) that requires the importer to pay the face amount either at sight (document against payment [D/P] or cash against documents) or on a specified future date (document against acceptance [D/A] or cash against acceptance).

7. Open Account

An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most advantageous options to the importer in terms of cash flow and cost, but it is consequently one of the highest risk options for an exporter. Because of intense competition in export markets, foreign buyers often press exporters for open account terms since the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may lose a sale to their competitors. When offering open account terms, the exporter can seek extra protection using export credit insurance.

8. Receivables Discounting

The finance houses and market allow and facilitate sales of receivables in the form of invoices, post dated-cheques or bills of exchange at a discounted price in return for immediate payment. The discount rate, which is relatively high and can be costly for SMEs, is calculated based on the risk of default, creditworthiness of the seller, and whether the transaction is international or domestic.

Export Credit Insurance

Export credit insurance (ECI) protects an exporter of products and services against the risk of nonpayment by a foreign buyer. In other words, ECI significantly reduces the payment risks associated with doing business internationally by giving the exporter conditional assurance that payment will be made if the foreign buyer is unable to pay. Simply put, exporters can protect their foreign receivables against a variety of risks that could result in non-payment by foreign buyers.

Exporters assume the risk of the uncovered portion of the loss and their claims may be denied in case of noncompliance with requirements specified in the policy. ECI does not cover physical loss or damage to the goods shipped to the buyer, or any of the risks for which coverage is available through marine, fire, casualty or other forms of insurance.

Role of Export Credit Guarantee Corporation of India

ECGC began its operations with credit insurance policies to exporters but soon, the focus also turned towards products for banks, starting in 1957. The schemes to banks were evolved to enable exporters to avail easy and hassle-free access to export finance which significantly enhances an exporter's ability to compete in the global market.

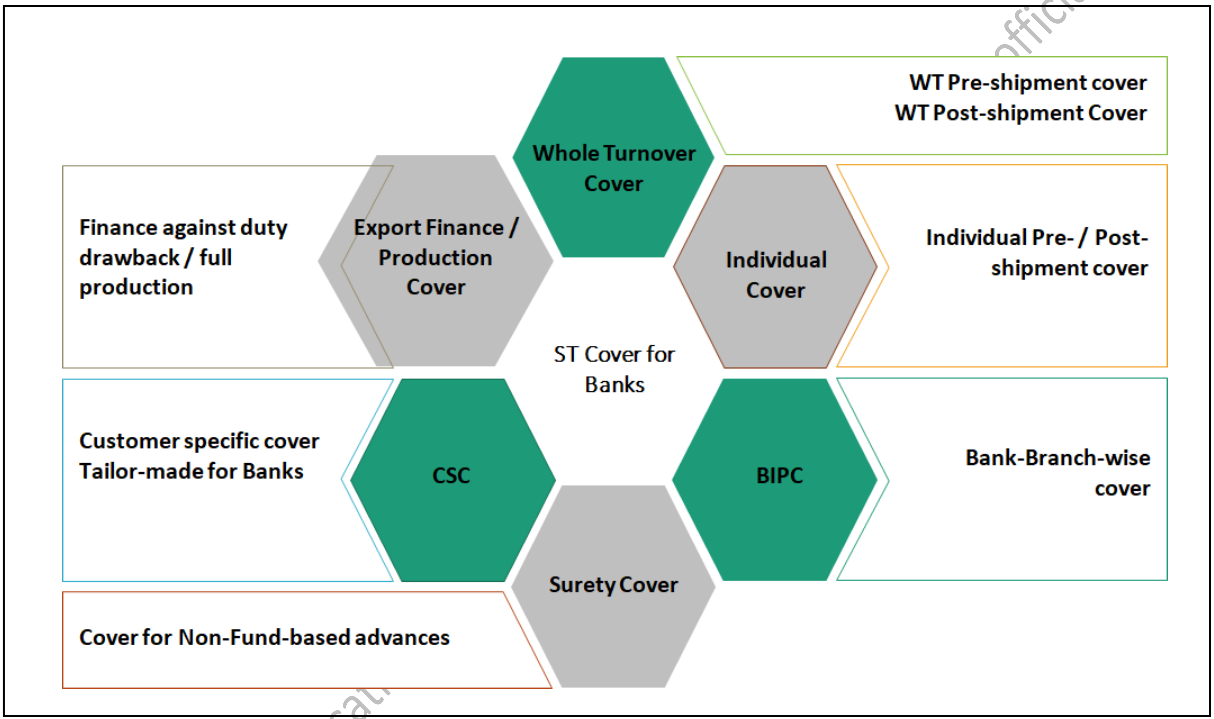
Export credit insurance is normally divisible into commercial and political risks. The commercial risk is that which rests with the buyer, i.e. their ability to pay for what has been purchased. The political risk is that associated with the buyer's country and includes losses arising from such events as the cancellation of an import license, war and the prevention by the authorities in the buyer's country of the transfer of the foreign exchange required to pay the seller.

Objectives of ECGC

Guide	Guiding export-related activities.
Recover	Helping Indian exporters recover bad debts.
Rating	Providing information on the credit-worthiness of foreign buyers.

Bank covers by ECGC

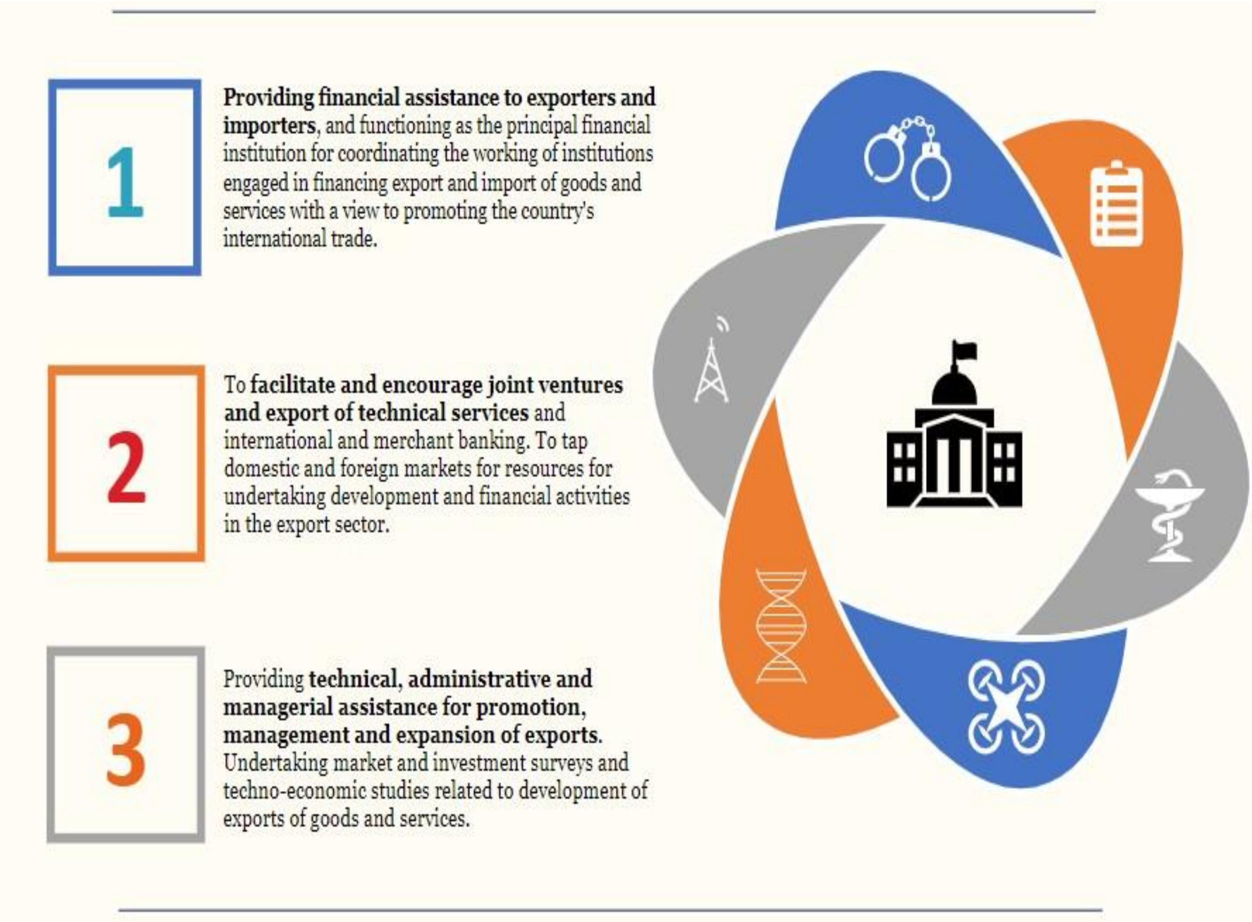
While Banks have the option of taking covers exporter-wise, bank-wise and bank branch-wise, the bank-wise covers, known as whole turnover covers (portfolio) are very popular. The cover provides for certain pre-agreed exclusions. Whole turnover covers also provide automatic cover up to certain specified value (discretionary limit), giving flexibility to banks to extend export credit to any new firms for MSMEs which carry higher risks in the early stages of venture. ECGC introduced the Export Performance Guarantee Scheme to the banks to protect the banks against losses on account of failure of exporters against the non-fund based facilities extended in the form of issue of guarantees like bid bonds, performance bonds, advance payment guarantee bonds and retention money guarantee bonds in the year 1969, and presently the scheme is in operation by in the name of Surety Covers, since 2013.



Support during Global Financial Crisis

The 2008-09 global financial crisis will be remembered as one of the broadest, deepest and complex crises since the Great Depression. The crisis affected both trade finance and other financial markets. The impact of the 2008 meltdown and the resultant slowdown in international trade impacted India greatly. The Indian banks faced major defaults from their exporter customers arising out of buyer failures. ECGC compensated banks to the tune of INR 6,000 crore in the last decade beginning from the meltdown. The support provided by ECGC enabled a stable export credit framework in the country during the tumultuous period. The support continues and even in the year 2016-17, INR 5,70,000 crores worth disbursements were covered under the covers extended to banks, which represents approximately 62% of the total disbursements.

EXIM Bank of India



With offices spread across the country and in select locations of the world, the EXIM bank aspires to boost the businesses of budding entrepreneurs and SMEs by acting as a facilitator and helping them navigate the complexities and intricacies of foreign trade.

Summary

To succeed in today's global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by the appropriate payment methods. Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer.

Thus trade finance provides support in four major areas as seen above. They include **Payment facilitation**, enabling secure and timely payment across borders, for example, through proven communication methods, such as SWIFT1 (a secure bank-to-bank messaging system used to transmit bank instruments, such as letters of credit, as well as payments between financial institutions). Secondly**, financing** to one or more parties in a trade transaction, whether it is the importer, exporter, or one of the banks. The third area is **Risk mitigation**, either directly through the features available in a trade financing mechanism or indirectly through insurance or guarantee products designed to meet the needs of importers and exporters. Finally, trade finance services also include **providing information** on the movement of goods and the status of the related financial flow.

The importance of trade finance is assuming a larger proportion in today's more connected world, with a great amount of financial uncertainty and it is imperative that the provider protect itself against any kind of commercial and political risks. The reliability of the buyer and their creditworthiness are key to the overseas transaction, as it takes longer to get paid. Trade financing is a huge driver of economic development and helps maintain the flow of credit in supply chains. Most businesses require financing at some stage, particularly those in the international export or global supply chain trade where capital costs are high and profitability is greater when order volumes are high. Apart from economic benefits like job and wealth creation, individual companies benefit from export finance as it generally increases productivity, profitability and growth.

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