SOUTH INDIAN Bank

Students' ECONOMIC FORUM

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To kindle interest in economic affairs...
To empower the student community...

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TRADE FINANCE

Part - I

July 2024 | Theme 391

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"The importance of money flows from it being a link between the present and the future"

- John Maynard Keynes

The 'SIB Students' Economic Forum' is designed to kindle interest in the minds of the younger generation. We highlight one theme in every monthly publication. Topics of discussion for this month is "TRADE FINANCE - Part I"

Trade Finance refers to the financial instruments and products that are used by companies to facilitate international trade and commerce. It includes a range of financial products such as letters of credit, trade credit insurance, factoring, and export financing. The primary purpose of trade finance is to mitigate the risks associated with international trade, improve cash flow, and ensure that exporters and importers receive their goods and payments on time. By providing credit facilities and payment assurances, trade finance helps bridge the gap between exporters and importers, enabling smooth transactions despite the complexities and uncertainties involved in cross-border trade.

Key Terms:

Letter of Credit (LC): A financial document issued by a bank that guarantees the buyer's payment to the seller will be received on time and for the correct amount. In case the buyer is unable to make a payment, the bank covers the full or remaining amount.

Bill of Exchange: A written order used primarily in international trade that binds one party to pay a fixed amount of money to another party on demand or at a predetermined date.

Promissory Note: A financial instrument that contains a written promise by one party to pay another party a definite sum of money either on demand or at a specified future date.

Factoring: A financial transaction and a type of debtor finance in which a business sells its accounts receivable (invoices) to a third party (a factor) at a discount.

Forfaiting: A financial transaction involving the purchase of receivables from exporters by a forfaiter who assumes all the risks involved in the receivables in exchange for cash.

Trade Credit Insurance: An insurance policy and risk management product that protects against the risk of non-payment of trade debt. It ensures that the seller gets paid even if the buyer defaults.

Open Account: A payment method where goods are shipped and delivered before payment is due, which is usually in 30 to 90 days.

Documentary Collection: A process by which banks handle the exchange of shipping documents for payments, involving two types: Documents against Payment (D/P) and Documents against Acceptance (D/A).

Key Concepts:

Risk Mitigation: Trade finance instruments like letters of credit and trade credit insurance help mitigate risks such as non-payment, currency fluctuations, and political instability.

Cash Flow Management: Trade finance solutions such as factoring and forfaiting help businesses manage their cash flow by providing immediate funds against future receivables.

Trust Building: Instruments like letters of credit build trust between buyers and sellers by ensuring that payment will be made upon the fulfillment of agreed terms.

Financial Intermediaries: Banks and financial institutions act as intermediaries in trade finance transactions, providing guarantees and facilitating the smooth exchange of goods and payments.

Credit Enhancement: Trade finance can enhance a company's credit by providing secure payment methods, reducing the risk of bad debts, and improving overall financial stability.

Payment Methods in International Trade

1. Cash in Advance:

In a cash in advance payment method, the buyer pays the seller upfront before the goods are shipped. This payment can be made via bank transfer, credit card, or other electronic payment methods.

Benefits:

- For the Seller:
  - Eliminates credit risk as payment is received before shipment.
  - Improves cash flow and liquidity by receiving funds upfront.
- For the Buyer:
  - May receive discounts for early payment.
  - Ensures that the seller prioritizes their order due to upfront payment.

Risks:

- For the Seller:
  - Very minimal risk as payment is received in advance.
- For the Buyer:
  - High risk of non-receipt of goods or receipt of defective goods.
  - Limited recourse in case of disputes as payment is already made.

2. Letters of Credit (LC)

Types of LCs:

- Revocable LC: Can be amended or canceled by the issuing bank without prior notice to the beneficiary.
- Irrevocable LC: Cannot be altered or canceled without the agreement of all parties involved.
- Confirmed LC: Another bank (usually in the seller's country) guarantees the payment in addition to the issuing bank.
- Unconfirmed LC: Only the issuing bank guarantees the payment.
- Sight LC: Payment is made upon presentation of documents.
- Usance LC: Payment is made after a specified period (e.g., 30, 60, 90 days) from the presentation of documents.

How LCs Work:

- Issuance: The buyer applies for an LC from their bank (issuing bank), specifying terms and conditions.
- Notification: The issuing bank notifies the seller's bank (advising bank) about the LC.
- Shipment: The seller ships the goods and presents the required documents to the advising bank.
- Verification: The advising bank verifies the documents and forwards them to the issuing bank.
- Payment: The issuing bank checks the documents. If everything is in order, the payment is made to the seller.

Benefits:

- For the Seller:
  - Assurance of payment if compliant documents are presented.
  - Reduced risk of non-payment.
- For the Buyer:
  - Ensures shipment of goods before payment.
  - Reduces risk of non-receipt of goods.

Risks:

- For the Seller:
  - Possible discrepancies in documents may delay payment.
  - Costs associated with obtaining an LC.
- For the Buyer:
  - Risk of receiving substandard goods.
  - Complexity and cost of LC issuance and amendment.

3. Documentary Collections

Documents against Payment (D/P):

- The seller instructs their bank to release shipping documents to the buyer only upon payment. The buyer must pay the amount stated to receive the documents needed to claim the goods.

Documents against Acceptance (D/A):

- The seller instructs their bank to release shipping documents to the buyer only upon acceptance of a bill of exchange. The buyer agrees to pay on a specified future date.

Benefits:

- For the Seller:
  - Control over the documents until payment or acceptance is received.
  - Less expensive than LCs.

- For the Buyer:
  - Delays payment until receipt of documents.
  - Can inspect documents before payment or acceptance.

Risks:
- For the Seller:
  - No payment guarantee (risk if the buyer defaults).
- For the Buyer:
  - May be obligated to pay or accept the bill of exchange without inspecting the goods.

4. Open Account

Terms and Conditions:
- The seller ships goods and sends the invoice to the buyer. The buyer pays within an agreed period (e.g., 30, 60, 90 days).

Benefits:
- For the Buyer:
  - Favorable cash flow, as payment is made after receipt of goods.
  - No upfront payment required.
- For the Seller:
  - May increase sales by offering attractive payment terms.

Risks:
- For the Seller:
  - High risk of non-payment.
  - Exposure to buyer's credit risk and financial stability.
- For the Buyer:
  - Minimal risks as payment is made after receipt and inspection of goods.

5. Consignment

- In a consignment arrangement, the seller ships goods to the buyer (consignee), but retains ownership until the goods are sold by the buyer to the end customer. Payment is made to the seller after the goods are sold.

Example:
- A manufacturer ships products to a distributor, who sells them in their local market. The distributor pays the manufacturer only for the products sold and returns any unsold inventory.

Benefits:
- For the Seller:
  - Potentially larger market access and increased sales.
  - Reduced inventory costs if goods are returned.
- For the Buyer:
  - No upfront payment required.
  - Can return unsold goods.

Risks:
- For the Seller:
  - Risk of non-payment or delayed payment.
  - Potentially higher costs for managing unsold goods.
- For the Buyer:
  - Minimal financial risks, but potential logistical challenges in handling returns.

Trade Finance Instruments

1. Bills of Exchange:
- A bill of exchange is a written, unconditional order by one party (the drawer) directing another party (the drawee) to pay a certain sum of money to a third party (the payee) at a specified future date or on demand.

Uses:
- Commercial Transactions: Used in domestic and international trade to facilitate transactions between buyers and sellers.
- Financing: Can be discounted with a bank to obtain immediate cash before the bill's maturity date.
- Credit Instrument: Acts as a formal credit instrument, ensuring payment at a later date.

2. Promissory Note:
- It is a financial instrument containing a written promise by one party (the issuer or maker) to pay a definite sum of money to another party (the payee) either on demand or at a specified future date. Example: (Mortgage Notes) Homebuyers sign promissory notes when obtaining a mortgage, agreeing to repay the loan in installments.

3. Trade Credit Insurance:

It is a risk management tool that protects businesses against the risk of non-payment by their buyers. It covers losses resulting from a buyer's insolvency or default on payment.

Purpose:

- Risk Mitigation: Reduces the risk of non-payment and bad debts.
- Business Expansion: Allows companies to extend more credit to buyers, facilitating business growth and expansion.
- Financial Stability: Enhances a company's financial stability and creditworthiness by securing receivables.

Benefits:

- Improved Cash Flow: Ensures that businesses receive payment, improving cash flow.
- Increased Sales: Encourages sales growth by allowing companies to offer credit terms confidently.
- Risk Management: Provides comprehensive risk management by covering political and commercial risks.
- Financing: Insured receivables can be used as collateral for financing.

4. Factoring and Forfaiting:

Factoring is a financial transaction where a business sells its accounts receivable (invoices) to a third party (factor) at a discount in exchange for immediate cash. The factor advances a percentage of the invoice value to the business and assumes the responsibility of collecting payment from the buyer.

Forfaiting is a financial transaction where an exporter sells its medium to long-term receivables (usually evidenced by promissory notes or bills of exchange) to a forfaiter at a discount, in exchange for immediate cash. The forfaiter assumes all the risks associated with the receivables, including political, commercial, and transfer risks.

Differences:

- Term:
  - Factoring is typically used for short-term receivables.
  - Forfaiting is used for medium to long-term receivables.
- Recourse:
  - Factoring can be with or without recourse (the factor may or may not have the right to claim reimbursement from the seller if the buyer defaults). Forfaiting is without recourse (the forfaiter assumes all the risks).
- Collateral:
  - Factoring does not usually involve negotiable instruments.
  - Forfaiting involves negotiable instruments like promissory notes or bills of exchange.

Advantages and Disadvantages

Factoring:

- Advantages:
  - Immediate cash flow improvement.
  - Outsourcing of credit control and collections.
  - Flexible financing option based on sales.
- Disadvantages:
  - Higher cost compared to traditional financing.
  - Potential impact on customer relationships due to third-party collections.
  - May require recourse arrangements.

Forfaiting:

- Advantages:
  - Immediate cash flow from medium to long-term receivables.
  - Transfer of all risks to the forfaiter.
  - Simplified financing process with no recourse.
- Disadvantages:
  - Higher discount rates compared to short-term financing.
  - Limited to specific transactions involving negotiable instruments.
  - Requires detailed documentation and compliance with international trade practices.

Recommendations:

- https://www.investopedia.com/terms/t/tradefinance.asp#:~:text=What%20Is%20Trade%20Finance%3F,to%20transact%20business%20through%20trade

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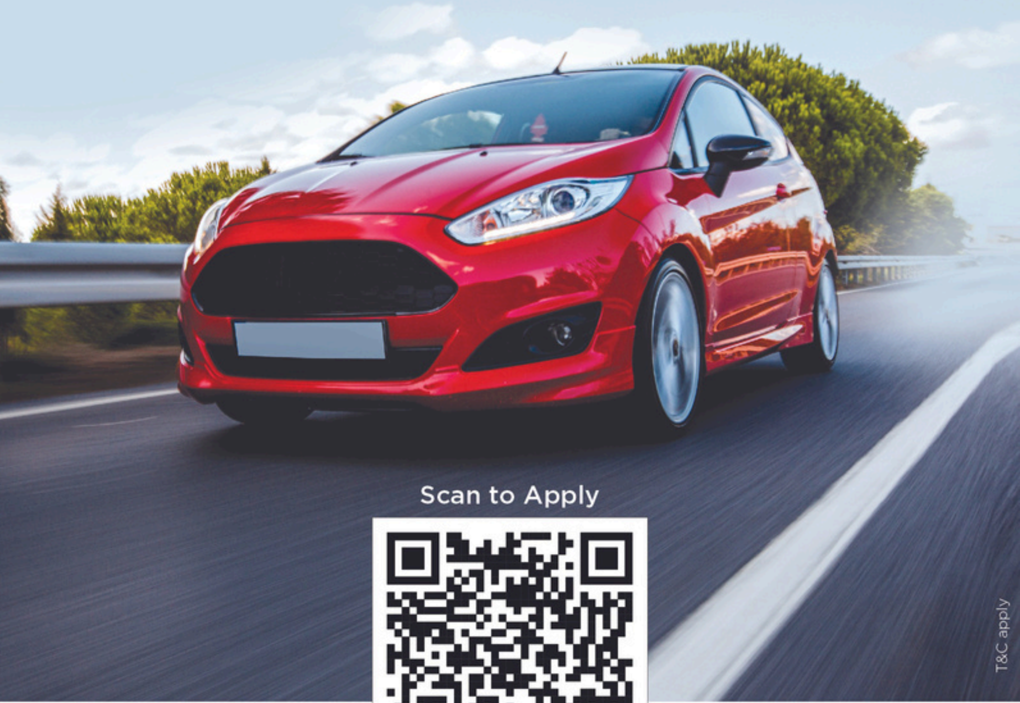

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