ROLE OF TRADE FINANCE

Hemanshu Kapadia
Proprietor, Practicing Company Secretaries, Hemanshu Kapadia and Associates, Mumbai, India
Email: hemanshu@hkacs.com

ABSTRACT

Trade Finance plays vital role in developing countries to enhance export competitiveness. Trade financing can be planned as a safe mode of financing, both for the long and short term. As it provides flexibility to the movement of goods and services worldwide, trade financing has been used in more than 90% of trade transactions (mostly short term credit) in the world.

Keywords: Trade Finance

INTRODUCTION

Definition

According to Campbell R. Harvey, trade finance refers to financial transactions involving the exports and imports. This could involve payment facilities, down payments, hedging, guarantees, and transportation linked issues.

The term "Trade Finance" means, finance for Trade. For a trade transaction there should be a Seller to sell the goods or services and a Buyer who will buy the goods or use the services. A variety of mediators such as banks and financial institutions play a very important role in facilitating the trade transaction by financing the trade. The absence of an adequate trade finance infrastructure is, in effect, equivalent to a barrier to trade. Limited access to financing, high costs, and lack of insurance or guarantees are likely to hinder the trade and export potential of an economy. Trade facilitation aims at reducing transaction cost and time by streamlining trade procedures and processes. One of the most important challenges for traders involved in a transaction is to secure financing so that the transaction may actually take place.

OBJECTIVES OF THE STUDY

1. To study the product under the umbrella of trade finance.
2. To understand the review of literature in related area.

Importance/Benefit of Trade Finance

Trade finance plays a very crucial role to solve not only liquidity problems but also promotes to their business organization to the maximum extent. Trade finance provides various benefits to such businesses like:

1. Rapid growth which has consumed all available cash
2. Additional inventory or raw material purchases where price increases have materially exceeded inflationary rises
3. Increasing product range
4. Freeing up general banking facilities blocked by Letters of Credit

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5. Seasonal or cyclical cash flow fluctuations which are not catered for by general banking facilities.

6. Opportunistic purchases of parcels of inventory from time to time

7. Taking advantage of early settlement discounts from suppliers

8. Improved pricing for bulk orders

9. Obtaining better shipping rates by consolidating orders

10. Dispensing with the need to offer settlement discounts which erode gross margins

11. Avoiding the need to change commercial banking relationships to obtain higher facilities

12. Additional layer of funding over and above normal banking lines which provides added flexibility

**Trade Finance Products**

There are hundreds of trade finance products which are useful to different—different industries as per their needs and demand. Some of the important trade finance products which are using regularly are as follows:-

1. **Factoring:** Factoring is a financial option for the management of receivables. In simple definition it is the conversion of credit sales into cash for the short term period i.e. for 15, 30, 60, 90 days or maximum up to the approved trade cycle. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 70% to 90% of the amount immediately of the invoice value. Factoring company pays the balance 10% to 30% (after deducting finance cost i.e. Interest Cost & Invoice handling charges and Service Tax) to the customer when the factor received 100% amount on the due date from the client’s debtors.

The account receivable in factoring can either be for a product or service. Examples are factoring against goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt in the stipulated period of factoring, Contractors submit invoices to get cash instantly) etc. There are various types factoring like Null factoring, Recourse factoring, Maturity factoring, Advance factoring, Bulk factoring, Invoice discounting, Agency factoring, Single/Direct Factoring, Direct export factoring, Direct import factoring and Back to back factoring etc.

**Working of Factoring:**

2. **Channel Financing:** Channel Financing is an innovative option for extending working capital finance to dealers who have business relationships with large companies. Channel Financing is the mechanism through which a Bank / Financial Institution meets the various funds related requirements along the Supply Chain at the suppliers end. This thereby helps the supplier in sustaining a seamless business flow and avoiding Working Capital related difficulties. Channel Finance usually covers
discounting of Trade Bills drawn by a company and accepted by its dealers, distributors or Channel Partners. It also provides overdraft facility to the dealers or distributors who have business dealings with large Corporate.

3. **Dealer finance**: Loans that are originated by a retailer to its customers and are then sold to a bank or other third-party financial institution is called dealer financing. The bank purchases these loans at a discount and then collects principle and interest payments from the borrower, it is also called an indirect loan. A well-known example of dealer financing is auto dealers that offer car purchase financing. Many car dealer’s markup the finance company’s interest rate and keep the difference as additional profit. Let us see below how the dealer financing works:

4. **Warehouse Financing**: A form of inventory financing in which loans are made to manufacturers and processors on the basis of goods or commodities held in trust as collateral for the loans. The goods may be held in public warehouses approved by the lender, or may be held in field warehouses located in the borrower's facilities but controlled by an independent third party. A financial institution engaged in warehouse financing will usually designate a collateral manager who issues a warehouse receipt to the borrower that certifies the quantity and quality of the stored goods or commodities.

5. **Pre Shipment Finance**: Pre Shipment Finance is issued by a financial institution when the seller wants the payment of the goods before shipment. The main objectives behind preshipment finance or pre export finance are to enable exporter to procure raw material, carry out manufacturing process, provide a secure warehouse for goods and raw materials, process and pack the goods, ship the goods to the buyers and meet other financial cost of the business.

6. **Post Shipment Finance**: Post Shipment Finance is a kind of loan provided by a financial institution to an exporter or seller against a shipment that has already been made. This type of export finance is granted from the date of extending the credit after shipment of the goods to the realization date of the exporter proceeds. Exporters don’t wait for the importer to deposit the funds.

7. **Letter of Credit (LC)**: LC is a commercial document issued by a bank in normal course of business which carries a payment guarantee obligation in case of adverse situation arises. A bank issue LC on the request of its client in favor of a third party (beneficiary). It is important instrument to the extent that it smoothens & secures the transactions ensuring to the party in whose favor the LC is opened that if any adverse situation arises and its client failed to make the payment than the issuing bank will pay subject to the terms and conditions mentioned at the time of issue of LC. This document is most important in case both the parties doing business first time. These parties can do business without any or very low risk, as bank gives a safety assurance to both the parties, involved with the transaction. There are various types of Letter of credit: Import/ Export LC, Revocable LC, Irrevocable LC, Confirmed LC, Confirmed LC, Unconfirmed LC, Nontransferable LC, Deferred/Usance LC, At sight LC, Red Clause LC and Back to Back LC etc.

**Issuance of Letter of Credit**

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<th>Buyer/Importer</th>
<th>1</th>
<th>Beneficiary/Exporter</th>
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<tbody>
<tr>
<td>2</td>
<td>Request for a Letter of Credit</td>
<td>4</td>
</tr>
<tr>
<td>Issuing Bank</td>
<td>3</td>
<td>Advising/Confirming Bank</td>
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</table>

| Request to advice and possibly confirm the Letter of Credit | 3 |
| Advising/Confirming Bank |

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Payment under Letter of Credit

8. Bank Guarantee (BG): BG is a guarantee made by a bank on behalf of a customer (usually an established corporate customer) should it fail to deliver the payment, essentially making the bank a co-signer for one of its customer's purchases. Guarantees are important instruments used to minimize the risks that are involved in commercial contracts. For the enforcement of ordinary guarantees, as construed dependence of the guarantee on the main contract may lead to unnecessary disputes and litigation, arising from the main contract. These disputes may have a material effect on the guarantee, thereby blocking funds in litigation. Hence, there was a need for an innovative instrument which would enable the guarantee to serve its original purpose, namely, providing a form of security. The bank guarantee is one such innovative financial instrument whereby, if the beneficiary perceives that there has been a breach of contract by the other party, he can encash the guarantee and avail of the amount immediately, without having to undergo the hassles of litigation. Thus, the relevance of a bank guarantee achieves relevance. There are various types of Bank Guarantee: Financial BG, Performance BG and Differed Payment BG etc.

Working of Bank Guarantee

9. EPCG: The Export Promotion Capital Goods (EPCG) scheme was one of the several export-promotion initiatives launched by the government in the early '90s. The basic purpose of the scheme was to allow exporters to import machinery and equipment at affordable prices so that they can produce quality products for the export market. The import duty on capital goods — like all other items — was high during that period, inflating the cost of capital goods nearly 50%, so the government allowed exporters to import capital goods at only 25% import duty. For waiver of the remaining portion of import duty, exporters were supposed to undertake an 'export obligation' (a promise to export) which was worked out on the basis of the duty concession obtained.

CONCLUSION

Trade finance plays very important and active role to fulfill short term working capital requirements in a company. Apart from large scale business organization, small and medium scale business organizations are highly employment generated sources for India, but they also faces the problem of smooth flow of working capital. With the help of trade finance such problems solves to the maximum
extent. Trade Finance and secure payment systems should be part of our International Trade Policy. I hope the areas covered have at least provided a flavor of what can be gained by applying a practical approach to your trade finance needs.

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