SUPPLY SIDE: SOURCES AND INSTRUMENTS OF TRADE FINANCE

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1. Learning Objectives
2. Background
3. Sources of trade finance
4. Instruments of trade finance
5. Case Study: CRDB Bank Ltd
6. Impediments/Challenges in accessing trade finance
7. Questions and Answers
1.0 Objectives

- Appreciate the importance of trade finance
- Draw distinction between trade finance and regular lending
- Identify and distinguish various sources of trade finance
- Understand and be able to distinguish various instruments of trade finance.
- Appreciate challenges facing various stakeholders in need of trade finance.
2.0 Trade Finance - Background

Importer

Exporter

Open A/C, Bills acceptance

Financing Trade?

Importer/Exporter

Currency risks
Market risks

Advance Payment, Confirmed LC, Avalized Bills

Cotton lint
Trade finance is more than regular lending. It refers to innovative financial products and services that assist importers and exporters to fulfill their financing needs.

- Trade Finance is a source of working capital for many traders in need of financing to procure, process or manufacture products before sale in future.

- Trade finance is also important for individual traders and firms trading internationally, because it can shape competitiveness of their contract terms.

- Trade finance is therefore important for any country as it facilitates international trade. As international trade increases, so does the importance of trade finance.
Absence of an adequate trade finance infrastructure is, in effect, equivalent to a trade barrier.

- Importers facing difficulties in accessing trade finance, have limited chance to offer competitive terms to their suppliers the like of advance payment terms, Sight letters of credit, Bills avalized etc.

- Conversely, exporters with limited supply of trade finance, will have difficulties in penetrating the market, because while importer may prefer to buy on open account, or on deferred terms, the supplier may not be in position to accept/offer such terms.
3.0 Sources of Trade Finance: Commercial Banks

Commercial Banks are the main source of trade finance

- They provide **pre-export financing** (O/D, Term Loans)
- They help in the **collection process**
- They **issue and confirm letters of credit**
- They book **acceptance and discounting drafts**
- They offer **fee-based services** such as providing credit and country information on buyers.

Other roles played by commercial banks include

- Taking foreign exchange risks (spot, forward, swap etc)
- Taking market risks (options)
3. 1 Sources of Trade Finance: Commercial Bank cont...

Roles played by Commercial Banks

**Settlement**
(Terms of payments: Open A/C, Advance payments, Collections, L/C)

**Commercial Banks**

**Loans**
(OD, Term loans)

**Take market Risks**
(Price risk options, future, forward)

**Take currency risks**
(Spot, Swap, forward, Options)
Summary of trade finance sources from Commercial Banks:-

- Loans facilities, which may take the form of Working capital or overdraft and Term loan facilities
- Off balance sheet financing: -
  - Issuing performance, bid, custom, advance payment bonds etc
  - Opening letters of credit
  - Accepting and confirming letters of credit
  - Bills Avalisation
- Discounting documents under letters of credit
- Advance under red clause letters of credit
- Structured Finance
Supplier may offer credit to a buyer by releasing goods to a buyer against **bills of exchange**, by which a seller can get an undertaking from the buyer to pay at a specified future date.

Alternatively may decide to release the goods against **promissory notes**, in which a buyer promises to pay at a future date, but which offer less legal protection as compared to the bill of exchange.

Under **counter trade** arrangements valued goods are exchanged at an agreed value without cash or credit terms, involving a barter-exchange, counter-purchase, or buy-back.
Specialized house or other trading institutions may under **forfeiting** arrangement purchase from exporters receivables without recourse at a discounted rate to allow exporter access financing before maturity of the bill. In this case the receivable becomes a tradable security.
3.4 Sources of Trade Finance: Government and related institutions

Regional bank, community bank can be good source of trade finance especially in less developed economies where financial markets and money markets are underdeveloped.

- Establish scheme of guarantees to support exporters
- Establish floating line of credit to support imports for and exports from specific sectors, e.g. confirmation line
- Establish guarantees schemes for SME, Micro group
- Embark on support policies, e.g. tax deferral for export
4.0 Instruments of Trade Finance

- Letters of Credit (Documentary Credit)
- Bank Guarantees
- Pre and Post shipment finance loan facilities
- Buyers and Sellers credit
- Bills Acceptance and Avalisation
- Structured Finance
- Leasing
- Factoring and Forfaiting
- Countertrade
A Letter of Credit is a document issued by a bank (issuing bank) stating its commitment to pay a seller (beneficiary) a stated amount of money on behalf of a buyer so long as the seller meets very specific terms and conditions.

- Letters of Credit are either issued as “Revocable” or “Irrevocable” form and are either “Unconfirmed” or “Confirmed”, payable at “Sight” or at a deferred period “Usance”.

- The classification of Letters of Credit also includes special types, namely: Revolving letters of credit, Standby Letter of Credit (SBLC), Red Clause letters of credit, Transferable letter of credit, and Back-to-back letters of credit.
Documentary credits they facilitate trade financing in the following ways:

- Letters of credit issued against L/C facility allows importer to delay payments to exporter, thus easing cash flow problems and interest expenses.

- It allows supplier to access credit against presentation of documents at the counters of negotiating bank without waiting for goods to reach the buyer.

- It allows buyer to obtain credit terms from a seller under Usance or differed L/C terms whereby the bank books acceptance for payment of bills to be made at future agreed date (maturity date).

- Supplier can discount documents and obtain credit before due date.

- Red clause Letters of credit allows exporter to obtain pre-export advance payment.
A Letter of guarantee is a written promise issued by the Bank to compensate (pay a sum of money) to the beneficiary (third party, local or foreign) in the event that the obligor (customer) fails to honor its obligations in accordance with the terms and conditions of the guarantee/agreement/contract. Types include Bid, Custom, Payment, Performance, Advance payment, Government export guarantees etc.

- **Advance payment** guarantee allows its beneficiary to access advance payments to facilitate procurement or production of goods for delivery to the intended party

- **Custom Bonds** allow a buyer or seller to postpone payment of tax until the goods are sold

- **Customs Bonds for Temporary Transit** facilitates movement of goods on transit or sent abroad for a trade fair, or goods, which are imported with intention of re-exportation without paying related custom duties.
Structured finance is the art of transferring risks in trade financing from parties less able to bear those risks to those more equipped to bear them in a manner that ensures automatic reimbursement of advances from the underlying assets.

- Typical examples of structured finance include
  - Inventory/Ware house financing
  - Receivable financing
4.3 Instruments of Trade Finance: Structured finance Cont...

- **Farmer**
  - Payments
  - Commodities

- **Financial Institutions**
  - Price Risk Options?
  - Financing (Loan facility)

- **Private Buyers or Cooperative Union**
  - Commodities

- **Warehouse men**
  - Warehouse receipt + Reports
  - Sales Contract

- **Buyer**
  - Payments
  - Commodities
4.4 Instruments of Trade Finance: Leasing

❖ Leasing

❖ It is more useful for long term financing needs, e.g. for acquisition of equipment or machinery requiring large sum of cash outlay.

❖ Under leasing such can be acquired without having to make a large one-time cash outlay.

❖ Usually a leasing company will purchase and lease to a company in need against monthly rental fee.
Factoring and Forfaiting

- Are both forms of receivables discounting

- A specialized financial firm pays company cash up-front for the amounts due to them by their customers.

- While **Forfaiting** is mostly used for international transactions, **Factoring** is mostly used for domestic trade.

- **Factoring** is the assignment by a supplier of receivables arising from contracts of sale of goods made between the supplier and its customers (debtors) to a factor.
The factor can pay for the accounts receivable (invoices) in different ways:

- **Advance-based factoring**
- **Maturity-based factoring**
- **Collection-based factoring**

**Forfaiting** is the term generally used to denote the purchase of obligations falling due at some future date, arising from deliveries of goods and services—mostly export transactions—without recourse to any previous holder of the obligation.
In a forfaiting transaction, an exporter/seller remits guaranteed debt, which results from a sale on credit, to a forfaiting company.

The forfaiting company pays him cash, up-front, the face value of the debt minus a discount.

The debt has to be enhanced through an aval or guarantee from a bank or other financially strong institution.

Once the debt has been accepted by the forfaitee, the exporter is no longer liable for a failure of the buyer to pay-the forfaitee, except where there was element of fraud.
Countertrade involves the exchange of goods and/or services as a condition of purchase, or as financing of purchases

- Under such arrangements valued goods are exchanged at an agreed value without cash or credit terms.

- It is particularly valuable in markets where there is a shortage of foreign exchange reserves, where the currency is not freely convertible, or where there is difficulty in obtaining export credits.

- It is an umbrella term for a range of reciprocal or compensatory trade mechanisms including barter, compensation, counterpurchase, buyback, offset, switch trading and tolling.
5.0 Case Study: CRDB Bank Ltd

CRDB BANK LIMITED

- A Tanzania private local commercial bank with over 11,000 shareholders categorized as follows:
5. Case Study: CRDB Bank Ltd Cont.....
5.1 Case Study: CRDB Bank Ltd & Commodity Financing

- Financing problems emerged immediately after liberalization (during 1980’s) when governments in many countries reduced its involvement in commodity marketing.

- The impact on farmers were two fold.
  - Firstly, they were exposed to price risks, which previously were absorbed by the Government.
  - Secondly, credit systems almost collapsed, negatively affecting productivity, reducing farmers income and forcing farmers to switch to other economic activities.
5.1 Case Study: CRDB Bank Ltd & Commodity Financing Cont…
### 5.1 Case Study: CRDB Bank Ltd & Commodity Financing Cont...

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6.0 Trade Finance Impediments and Challenges

- Lack of Security/Collaterals
- Absence of counter party willing to offer financing alternatives outside the banking system
  - Promissory notes, Bill of Exchange, Counter trade, Forfeiting, Suppliers credit etc.
- High costs of borrowing to compensate banks for credit risks (Interest rates, application fee, facility fee)
- Regulatory issues
  - Difficulties for importers and banks to comply with regulatory requirements e.g. Foreign currency controls
Compliance to terms of Trade
  • Documentations,

Absence of reliable Market information about
  • Counter party risks and trading requirements.

Missing link to buyers and sellers (Financial institutions link)

Infrastructure gap
  • Transportation, Storage, Clearing & forwarding.

Price Volatility for export especially commodities
Poor negotiations skills for some importers/exporters which have caused them to become victims of unfavorable terms in international trade.

- Overseas supplier insist on **Advance payments**, while Exporters are forced to accept **Open account terms**
- While overseas suppliers require L/C’s confirmed by first class bank, few of the L/C’s in favour of suppliers in Tanzania will request for confirmation.
- Even bank charges are not shared equally
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7.0 Discussions/Question & Answers
• End of Presentation &

THANK YOU