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Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: Finance and International Trade
Level: Second year Master

Lecture 03: Trade Finance

1-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.

2-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.

3- 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.