# Knowledge Paper
# on
# TRADE CREDIT: Its Relevance to Global Value Chains in Context to Indian MSMEs


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# Preface

MVIRDC World Trade Centre plays an active role in promoting, strengthening and enhancing India's international trade. Global trade has been witnessing severe slowdown and the reasons for the declining trend range from economic and political crisis to high currency volatilities, deep divide between developing and developed economies, etc. India's trade has suffered major drawback due to poor logistics, infrastructure, weak government policies and high volatility in rupee accounts.

The panel discussion on, "Trade Credit: Its Relevance to Global Value Chains in the context of Indian MSMEs" will focus on global value chains as an indispensable mechanism for integrating MSMEs in the evolving global trading system. It will highlight the imperatives of timely credit to MSMEs in facilitating and invigorating trade. Trade credit is a financial instrument of global trade which provides interim capital cushion to the exporters. This helps provide necessary buoyancy to the businesses to manage credit conditions when used strategically. Trade Credit holds valid and secured in a scenario of strong global value chains with less probability of default and high trust between the stakeholders as well; it curbs issues in trade by providing insulation against currency volatility, thereby ensuring steady exports and steady production and no wastage of inventory.

In pursuance of the goals and objectives of MVIRDC World Trade Center to promote international trade, the panel discussion and publication attempt to sensitize trade, industry and financial institutions of the paramount importance of trade credit as a vehicle of strengthening global value chains. It is our endeavor to promote and nurture MSME sector and to present to them the advantages of various facets of global trade.

I thank Ms Rupa Naik, Director - Projects and Dr Yadnya Pitale for planning and organizing this important session and compiling this useful publication.

**Y. R. Warerkar**
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# FOREWORD

Structural transformation and development in the 21st century is increasingly being driven by the ability of countries to participate and compete in the Global Value Chains (GVCs). As nearly 80-90 percent of the world trade currently relies on trade finance, attempts towards GVC integration hinges on the availability of trade credit.

In the wake of the global slowdown, access to trade finance becomes more crucial as the ability of firms to enmesh their operations in GVCs is constrained by limited liquidity, financial instability, weak economic recovery and low trade flows. While larger companies have access to alternative sources of finance such as external commercial borrowings, the SMEs are largely dependent on domestic routes. Exim Bank has been financing, facilitating and promoting trade from India, ever since its inception. Exim Bank has made seminal contribution towards facilitating trade credit flow to the MSME sector, focusing on various aspects including technology and innovation enhancement and infrastructure development.

It is indeed timely that MVIRDC World Trade Center has taken up the topic "Trade Credit: Its Relevance to Global Value Chain in context to Indian MSME". Global trade has transformative powers to bridge the gap between aspirations and achievement for firms in developing countries. Export-oriented industrialization has reaped benefits for several economies in not just the developmental paradigm but also in enhancing their stature in the global economic landscape.

Apart from alleviating the financial constraints, there is also an urgent need to make trade regulations unbiased and strengthen economic cooperation among regional economies. Regulatory reforms proposed under the Basel III norms also need to be tweaked in order to be more supportive of the trade finance framework.

I wish to convey my gratitude to Mr. Y.R Warerkar, Ms. Rupa Naik and Dr. Yadnya Pitale for bringing out this publication which is not only topical and informative but will also be an interesting read for all relevant stakeholders.

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April 7, 2016

# Acknowledgements

The publication titled as working paper on Trade Credit: Its relevance to Global Value Chain with reference to Indian MSME and the ensuing event on the same title has been planned to bring about the issues hampering global trade and suggest solutions in context to the same. Global trade in the Global Value Chain framework has always been steady and has allowed the required growth in economies to flourish. The event i.e the panel discussion and the research paper would not have been possible without the evident contribution from the team MVIRDC World Trade Center and the distinguished panelist and the audience which comprises of industry veterans and experts. Extend our sincerest thanks to Mr. Arun Sehgal, Dr. Sunjay Koyande, Mr. Suhas Thosar, Mr. Ritesh Singh, Mr. Utpal Gokhale, Mr. Venugopal Paidimarry, Mr. Saurabh Jain and Mr. Anurag Mishra for having contributed their rich experiences to this panel discussion. Also we extend our heartfelt thanks to Mr. Anish Shah and Mr. Mayank Tandon for facilitating the sponsorship. Last but not the least we thank all the stakeholders connected directly or indirectly to the success of this project.

# CONTENT

# Executive Summary

Credit culture in the present Indian economic scenario has strikingly betrayed the aspirations of the manufacturing business. Weakening of bank credit has given rise to a vicious cycle of weakening in the indirect financing like trade credit too . Exporters are troubled by limited funds and slowing demand are held back further, as factoring companies have tightened lending against payments that aren't insured.

Indian exporters are facing issues on several fronts such as a lack of trade credit, hard bargaining by buyers for steep discounts, payment defaults as well as the rising costs or a lack of credit insurance. This has led to payment cycles being stretched and an excessive build-up of inventory.

Trade credit is economically significant from both the micro- as well as a macroeconomic perspective. Trade credit is one of the most important sources of working capital for firms, not only in advanced economies, but in India as well. Trade credit accounts for roughly 11% of the external finance for large firms in India. In the case of SMEs, this proportion is nearly double at around 20%. Globally, the extant evidence appears to suggest that, on average 19.7% of all investment financed through external sources is via trade credit. Trade credit is the single most important source of external finance for firms and is used as a hedge for financing needs.

It appears on every balance sheet and represents more than one half of businesses' short term liabilities and a third of all firms' total liabilities with about 60% of all international trade transactions being financed via trade credits. Trade credits are extended bilaterally between firms and exist in the form of supplier credits and cash-in-advance. A supplier credit is granted from the seller of a good to the buyer such that the buyer can delay the payment of the purchasing price for a certain period of time. Cash-in-advance, in contrast, refers to payments made in advance by the buyer of a good to the seller.

The intensive use of inter-firm financing is surprising given that financial intermediaries such as banks are supposed to be more efficient in providing credit to firms. Inter-firm financing is considered rather expensive with implicit annual trade credit interest rates amounting up to 40% however, the fact that it is a direct type of finance in absence of formalities make it more attractive.

Cash-in-advance financing fosters export participation in particular of those firms that tend to experience greater difficulties in entering foreign markets. Cash-in-advance serves as a credible signal of quality and reduces part of the high uncertainty in international trade.

When conditions of volatility exist in exports making it less profitable, cash-in-advance can help firms overcome productivity frictions if other firms signal their reliability in form of cash-in-advance. Despite higher implied costs, this in turn can facilitate entry into exporting, in particular for less productive firms.

The recent collapse in international trade and doom in domestic manufacturing scenario, credit availability has had its relative impact on SME exporters. In particular, the small firm share of the dollar volume of total exports is adversely affected by deterioration in bank health, and the adverse impact is more pronounced for firms in industries that are more reliant on external finance, such as chemicals and textile mill products.

In contrast to large firms small, illiquid firms with little access to outside finance pass liquidity shocks on to their suppliers by defaulting on trade credit. If the supplier is also small and illiquid and cannot raise fresh funds on short notice, a substantial portion of the shock is likely to be passed on further down the trade credit chain. Large liquid firms with access to outside finance ultimately tend to absorb at least some of these shocks and hence inject new liquidity into the system. Trade credit default chains can serve a useful role in allocating liquidity to credit constrained firms.

Persistently sluggish industrial growth trend rate despite strong fundamentals, influx of FDI, implementation of a string of policy reforms in the last 4-5 years has led to clustering of delays/defaults in TC payment assisting the already present acute working capital crisis leading to growth crisis for large number of businesses. Trade credit flow system was based on trust and confidence channels however, deterioration of same has led to fall in credit culture. Making the credit-based segment of the payment system becoming increasingly vulnerable.

The formation of strong Global Value Chains necessarily overcomes these, one to one trade credit issues, a unique example to this is the GVCs formed by agro processing industry like Hindustan Lever Ltd, which outsources most of its agro inputs from region specific SMEs who have not encountered such issues and are running smoothly.

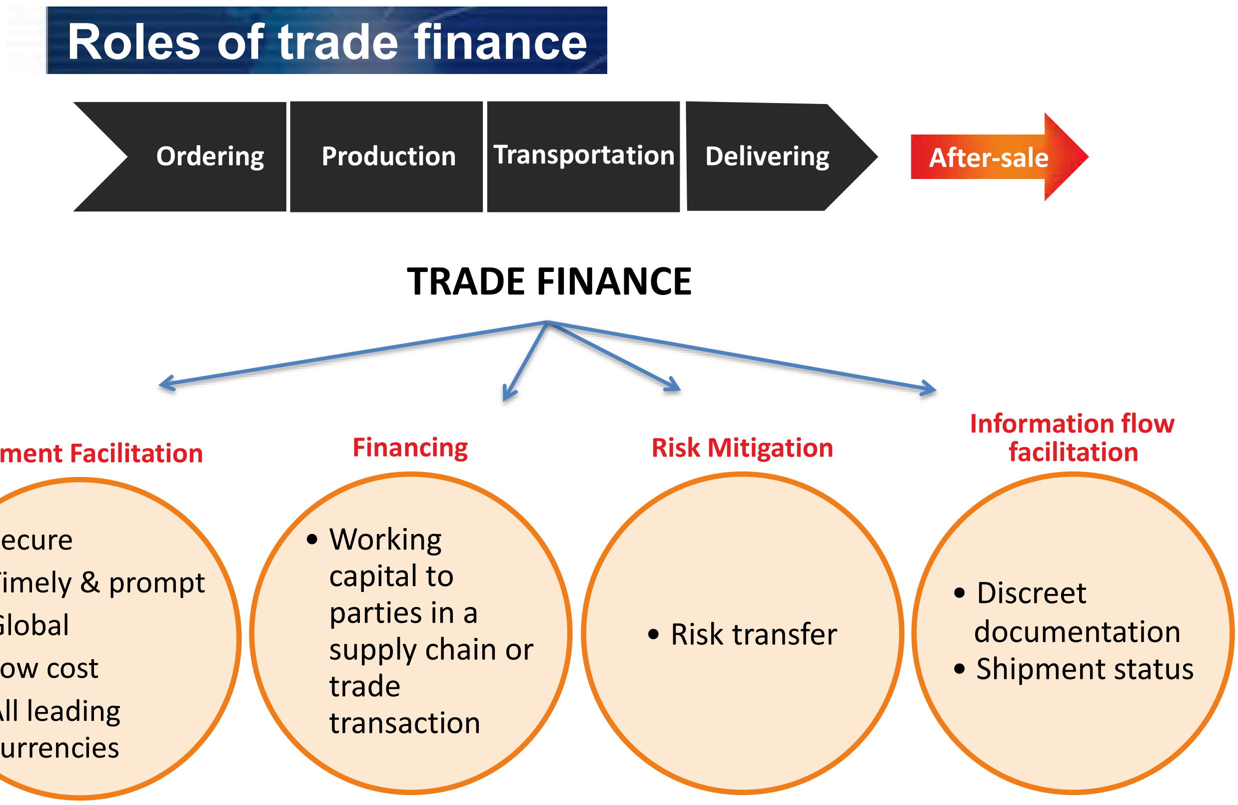
A Global value Chain ensures trust between the stake holders and there is an attempt made by these to bring about awareness among the stake holders through value training workshops and other motivational inspirations which gives a sense of connectedness in operations as learning and standardization is involved. Trade credit in such a global value chain also enhances the efficiency of the invested capital.

# Overview of Trade Credit


Chapter 1

# Overview of Trade Credit

**Trade credit is most rewarding for businesses that do not have many financing options. After the 2008 financial crisis, traditional financing options for small businesses, such as debt and equity financing, became increasingly limited. Evidence of this is seen in the relatively recent rise of alternative means of financing, such as crowd funding and peer-to-peer lending.**




From an international standpoint, studies have found that in countries beside United States, trade credit accounts for approximately 20% of all investment financed externally. Research indicates that bank credit was the only form of financing more significant than trade credit, showing that in most of the countries, trade credit was the second most important financing option.

Similarly, research conducted in the U.S., such as that of the Survey of Small Business Finances by the Federal Reserve Bank, demonstrates the importance of trade credit which is used by approximately 60% of small businesses in the U.S., rendering it the second most popular financing option after that of banks and other financial institutions.

Trade credit is probably the easiest and most important source of short-term finance available to businesses with predominance of export trade. Trade credit means many things but the simplest definition is an arrangement to buy goods and/or services on account without making immediate cash or cheque payments. It is a short-term credit extended by suppliers of goods and services in the normal course of business, to a buyer in order to enhance sales. Smaller companies with limited cash on hand often rely on trade credit to make inventory purchases on a regular basis.

Trade credit becomes a important source of finance due to the feature of deferral of payment when a supplier of goods or services allows customers to pay for goods and services at a later date. Trade credit is thus an important external source of working capital financing too. Trade Credits' (TC) such as suppliers' credit or buyers' credit refer to credits extended for imports directly by the overseas supplier, bank and financial institution for maturity of less than three years. Suppliers' credit refers to credit extended by the overseas supplier for imports into India whereas the buyers' credit refers to loans for payment of imports into India arranged by the importer from a bank or financial institution outside India for maturity of less than 3 years.

In case of Global Value Chains trade credit primararily exists in form of foreign currency and thus is regulated under the FEMA. Trade Credits availed by residents are governed by clause (d) of sub-section 3 of section 6 of the Foreign Exchange Management Act, 1999 read with Notification No. FEMA 3/ 2000-RB viz. Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000, dated May 3, 2000, as amended from time to time. Trade Credit refers to credit extended for imports directly by the overseas supplier, bank and financial institution for maturity up to five years. RBI permits banks to approve trade credits for imports into India up to USD 20 million per import transaction for imports permissible under the current Foreign Trade Policy of the DGFT. On the basis of the source of finance, trade credits may be either suppliers' or buyers' credit. Suppliers' credit relates to credit for imports into India extended by the overseas supplier, while buyers' credit refers to loans for payment of imports into India arranged by the importer from a bank or financial institution outside India for maturity up to five years. Buyer's Credit availed by the importers should be need based and tenure of the Buyers' Credit should be within their normal operating cycle. As per RBI Guidelines, trade credits for maturity period beyond 1 year is permissible only for capital goods for which the trade credits can be permitted upto USD 20 Mn. with maturity period of more than one year and less than 3 years (from the date of shipment). For periods beyond three years, upto five years, banks are not permitted to issue LC/LOU/LOC. No roll-over/extension will be permitted beyond the permissible period and banks are not authorized to approve trade credit exceeding USD 20 Mn. per import transaction. All-in-cost ceilings over 6 months' LIBOR for maturity period upto one year and more than one year but less than three years would be 350 bps for the respective currency of credit or applicable bench mark. Banks are permitted to issue LC/Letter of Undertaking (LOU)/Letter of Comfort (LOC)/ in favor the overseas supplier, bank and financial institution upto USD 20 Mn. per import of goods other than capital goods and for capital goods upto 3 years subject to prudential norms. Banks are also required to report the details of approvals, withdrawal, utilization, repayment, etc. of trade credits granted by branches in a consolidated statement and issuance of LC/LOU/LOC/guarantee by the branches in a consolidated statement on monthly and at quarterly intervals respectively to RBI. (Source: RBI M. Circular)

Buyers' credit is not permitted for the following kinds of transactions :

- Import of services
- Merchanting trade / intermediary trade
- Financing of advance payment for imports
- Purchase of goods by units in Domestic Tariff Area (DTA) from units in Special Economic Zone SEZ / 100% EOUs.

Suppliers' credit and buyers' credit for 3 years and above come under the category of ECB and governed by ECB guidelines.

- Features of Trade Credit:

The features of trade credit are given below:
1. There are no formal legal instruments/acknowledgements of debt.
2. It is an internal arrangement between the buyer and seller.

3. It is a spontaneous source of financing.

4. It is an expensive source of finance, if payment is not made within the discount period.

5.The difficulty of securing and enforcing credible commitments across borders makes trade finance more vulnerable in times of turmoil

Advantages of Trade Credit:

The advantages of trade credits are:
In short...
1. It is easy and automatic source of short-term finance.

2. It reduces the capital requirement.

3. It helps the business focus on core activities.

4. It does not require any negotiation or formal agreement.
In brief...
5. Induces increase in sale

From the perspective of the creditor, or supplier, trade credit induces more sales over time by allowing customers to make purchases without immediate cash. This flexibility in purchasing methods also encourages customers to make larger purchases when prices are right than they might if they had to pay cash upfront. Along with higher sales volume, trade credit often produces interest fees and late payment fees for creditors, which increases revenue. Trade credit is a helpful tool for growing businesses, when favourable terms are agreed with a business's supplier. This arrangement effectively puts less pressure on cashflow that immediate payment would make. This type of finance is helpful in reducing and managing the capital requirements of a business.

6. Encourages cashless transaction

From the resellers perspective, the ability to buy on credit makes it possible to buy needed inventory even when cash balances are low. Having cash to pay off long-term debt and other more urgent and immediate expenses is critical. The ability to delay cash requirements for supplies and inventory helps preserve cash for these purposes. Buyers may want to ramp up the volume of purchases at a time when demand is higher, and a trade account makes it more feasible to do so.

The reverse situation also needs to be considered; this is where customers or clients may request favourable trade credit terms. Put simply, any terms agreed with the customers or clients will reduce the benefit one has obtained through trade credit negotiations with the suppliers. For example, if one has agreed trade credit terms of 45 days with the suppliers and trade credit terms of 30 days with the customers or clients, the net benefit will be 15 days. It is the net amount that affects a business's working capital and a negative capital situation will need additional funding.

When a business enters into a trade credit arrangement with its suppliers, a limit is usually set, commonly called credit terms. For example, one could set cash, cheque or bank transfer payments to be made within 15 days from the date of the invoice, hopefully allowing one to still qualify for any early payment discount. If payments are not made within the terms, all outstanding amounts are required to be settled within the normal time period set from the date of purchase.

Credit terms will differ from business to business and industry to industry. Businesses that receive payments on delivery, for example online shopping sites, may have a shorter credit term than an industrial manufacturer. In that case, projects are spread over a longer period of time and payments may be received periodically on completion of certain pre-decided time slots.

7. Common Use

This is short-term finance that is relatively quick to arrange. The typical amount involved and the terms will depend entirely on the trading activity. The reverse is also common, where a business's customers or clients will request trade credit terms.

8. Business Growth- Sometimes, if a business is wanting to secure a contract with a bigger business, one will have to accept payment on their terms. Larger businesses tend to have their own payment terms they require. Unfortunately, they are large enough to know if someone doesn't say yes to those terms, someone else will. That being the case, many businesses have to offer trade credit just to secure a new job. Growth of the business is worth the risk and larger companies tend to be less risky.

9. Beat Out the Competition- On the other side of that, some businesses offer trade credit to remain competitive. Simply put, if a customer has to choose between a business who offers flexible payment terms and a business who doesn't, give the service and price is comparable, they will always choose the one extending credit. Therefore, some businesses extend credit to get a leg up on their competitors who are not.

10. Increase Sales- Not only can trade credit help one win a customer but it can also help increase the volume of one's sales. If a customer has more time to pay, it naturally increases their buying power. With more time, they purchase more, which means larger sales for the beneficiary.

11. Financial Stability- Extending credit is not a choice for businesses in tough financial times. Having a healthy cash flow is a must for businesses who want to extend trade credit. Therefore, if one is offering terms, it indicates that the business is in a good position financially. A strong financial reputation comes in handy when applying for loans or even when looking for suppliers to buy from.

If one is willing to provide a product or service prior to accepting payment, it means he is telling his customers and potential customers that he believes in quality of what he is selling. He is confirmed that his product will make customers happy sending a clear message to buyers and helps build product integrity. Also if one is extending payment terms to customers then offering trade credit can be a great way to show appreciation to long-term, loyal customers.

Disadvantages of Trade Credit:

Like other sources of finance, trade credit is also associated with certain disadvantages, which are as follows:
In short...
1. Trade credit is available only to those companies that have a good track record of repayment in the past.

2. For a new business, it is very difficult to finance working capital through trade credit.
In brief...
3. It is very expensive, if payment is not made on the due date.
If buyers are not careful in the way they use trade credit, they can end up paying much higher costs for inventory. Many companies offer a 2-percent discount if you pay within 10 days, but payments received after 30 days usually include late-payment fees and interest that begins accruing. In its overview of trade credit, "Entrepreneur" notes that purchases on account can cost between 12 to 24 percent extra in interest fees if the business does not pay within the typical 30-day net payment term.

There are three main indirect costs of trade credit as there is no direct cost involved:

- Loss of early payment discount
- Spoiling your relationship with your supplier if you do not adhere to the agreed trade credit terms
- Working capital cost if the net effect of receiving and providing trade credit puts one's business in a negative working capital situation.

The loss of the early discount can be taken into account when negotiating your trade credit terms. However, spoiling your relationship with your supplier can be more detrimental to your business and in extreme circumstances could tip a business into receivership. Therefore, any deviation from an agreement must be discussed with your suppliers before it becomes a problem.

4. Bad Debt

The potential risk to the supplier when offering trade credit is bad debt. If buyers do not pay off their debt, and in a timely manner, it has negative cash effects on the supplier. Companies eventually have to write off unpaid accounts as bad debt, which lowers their profits. Accounts that remain unpaid for a long period of time still have negative effects. This means the supplier has to wait to collect cash which it needs to pay its own bills.

Types of Trade Credit

Trade credit is a form of short-term financing, wherein a supplier will fulfill an order without requiring cash up front or on delivery. Instead, the supplier will extend trade credit terms specifying time frames within which the payment is due. Though several types of trade credit terms are commonly used, including net10, net30, net60 or net 90, suppliers can specify just about any terms to suit a customer's particular business model. Businesses often seek different types of trade credit from suppliers in order to conserve cash flow, while suppliers may extend different types of trade credit to help customers best sell their product. Furthermore, many suppliers will also extend trade credit and build in discounts for repayment ahead of the due date specified in the agreement, giving the customer various options depending on whether sales are slow or good.

The common types of trade credit, net10, net30, net60 and net 90, simply mean that the supplier is extending the due date of the payment for products delivered 10, 30, 60 or 90 days, respectively. Some types of industries involving high ticket items, which may have a longer selling cycle, may extend trade credit up to 180 days. Consignment is another option that allows a business to conserve cash flow while offering consumers products in demand. It is not considered a trade credit though, because the supplier still has ownership of products shipped until they are sold. Terms of payment on trade credit, however, usually involve foregoing discounts offered for payment upfront or cash on delivery.

Aside from the common types of trade credit terms extended, many suppliers will still build in discounts in addition to those offered for upfront payment. Referred to as cash discounts, they are often extended if the customer pays at a set date before the final due date. For example, a supplier might extend the following discounts on net60 terms: 20% discount for pay at net10, 15% discount for paying at net30, and 10% discount for paying at net45. Full payment is due at net60 if the invoice is not paid beforehand to take advantage of discounts offered. Discounts offered by suppliers are often used as incentives for businesses to generate sales, but also to afford the business options.

Businesses will often use trade credit terms extended in various ways, depending on how well products sell. If all products have sold within 10 days, the business can exercise the net10 discount and increase profits on the sale of the merchandise by 20%. On the other hand, if sales are extremely slow, the business can simply forgo any discounts and pay according to the terms at net60, while accruing the usual profit.

Trade Insurance

Credit risk protection solutions are required to protect the business from bad debt whilst maximizing profitability while pursuing trade. Competitive terms should be negotiated and secured in respect of cost, cover and service.

Current economic conditions have increased pressure on companies trading on credit terms. With continuing concerns over the impact of unexpected levels of bad debt, companies need to fully understand their credit risk profile and ensure they have sufficient balance sheet and cash flow protection. Strong and effective credit risk management is essential to protect and promote business growth.

For companies with branches or subsidiaries in different regional locations or countries, there is the added risk that inconsistent credit management procedures can lead to a lack of awareness of its overall exposure to customer failures or politically unstable markets.

Trade Credit insurance is the solution that is offered to companies that have to deal with the challenges described above.

Credit insurance covers the risk of non-payment of trade debt. Protection for political and pre-credit risk can also be added giving the confidence to trade on credit terms in uncertain economic times.

Advantages of Trade Credit Insurance

- Protects the profit & loss account and balance sheet against non-payment risk.
- Underpins ones credit management function and supports corporate governance best practice.
- Gives security in new markets allowing exporters to grow their business.
- Provides invaluable customer insight based on up to date company and economic analysis from credit risk specialists.

Importance of Credit Rating

Trade credit has a significant impact on the financing of businesses and therefore is linked to other financing terms and concepts. Other important terms that affect business financing and financial futures are credit rating, trade line and buyer's credit. A credit rating is an overall assessment of the credit worthiness of a borrower, whether a business or individual, based on financial history that includes debt repayment timeliness and other factors. Trade credit may not be offered to a business without a good credit rating.

A trade line, or tradeline, is the credit account record provided to a credit reporting agency, such as Standard & Poor's, Moody's or Fitch. Buyer's credit is related to international trade and is essentially a loan given to importers specifically to finance the purchase of capital goods and services. Buyer's credit involves different agencies across border lines and thus typically has a minimum loan amount of several million dollars.

Nature of international trade

- International transaction typically involves higher levels and numbers of risks (i.e. exchange rate risks, political and nonpayment risks)
- International active firms also have larger financial needs (e.g. the time lag between production and delivery)

# Trade Credit Products in the International Scenario


Chapter 2

# Trade Credit Products in the International Scenario

**Trade Credit is available in various forms and the prime stakeholders being buyer, seller and the bank. The main products have been discussed in this section to provide a general view of the same.**

Documentation for availing Trade Credit

While a seller (or exporter) can require the purchaser (an importer) to prepay for goods shipped, the purchaser (importer) may wish to reduce risk by requiring the seller to document the goods that have been shipped. Banks may assist by providing various forms of support. For example, the importer's bank may provide a letter of credit to the exporter (or the exporter's bank) providing for payment upon presentation of certain documents, such as a bill of lading. The exporter's bank may make a loan (by advancing funds) to the exporter on the basis of the export contract.

Other forms of trade finance can include, Trade Credit Insurance, documentary collection Factoring or forfaiting. Some forms are specifically designed to supplement traditional financing.

Secure trade finance depends on verifiable and secure tracking of physical risks and events in the chain between exporter and importer. The advent of new information and communication technologies allows the development of risk mitigation models which have developed into advance finance models. This allows very low risk of advance payment given to the Exporter, while preserving the Importer's normal payment credit terms and without burdening the importer's balance sheet. As trade transactions become more flexible and increase in volume, demand for these technologies has grown.

Banks and financial institutions offer the following products and services in their trade finance branches.

- Letter of credit: It is an undertaking/promise given by a Bank/Financial Institute on behalf of the Buyer/Importer to the Seller/Exporter, that, if the Seller/Exporter presents the complying documents to the Buyer's designated Bank/Financial Institute as specified by the Buyer/Importer in the Purchase Agreement then the Buyer's Bank/Financial Institute will make payment to the Seller/Exporter.
- Bank guarantee: It is an undertaking/promise given by a Bank on behalf of the Applicant and in favour of the Beneficiary. Whereas, the Bank has agreed and undertakes that, if the Applicant failed to fulfill his obligations either Financial or Performance as per the Agreement made between the Applicant and the Beneficiary, then the Guarantor Bank on behalf of the Applicant will make payment of the guarantee amount to the Beneficiary upon receipt of a demand or claim from the Beneficiary. Bank guarantee are of various types like 1. Tender Bond 2. Advance Payment 3. Performance Bond
- Collection and discounting of bills: It is a major trade service offered by the Banks. The Seller's Bank collects the payment proceeds on behalf of the Seller, from the Buyer or Buyer's Bank, for the goods sold by the Seller to the Buyer as per the agreement made between the Seller and the Buyer.

Some related Terms....

Documentary Collection

A documentary collection is a process, in which the seller instructs his bank to forward documents related to the export of goods to the buyer's bank with a request to present these documents to the buyer for payment, indicating when and on what conditions these documents can be released to the buyer.
The buyer may obtain possession of goods and clear them through customs, if the buyer has the shipping documents (original bill of lading, certificate of origin, etc.). The documents, however, are only released to the buyer after payment has been made ("Documents against Payment") or payment undertaking has been given - the buyer has accepted a bill of exchange issued by the seller and payable at a certain date in the future (maturity date) ("Documents against Acceptance").

Documentary Collections facilitate import/export operations. They do not provide the same level of security as Letters of Credit, but, as a result, the costs are lower. Unlike the Letters of Credit, for a Documentary Collection the bank acts as a channel for the documents but does not issue any payment covenants (does not guarantee payment). The bank that has received a documentary collection may debit the buyer's account and make payment only if authorised by the buyer. Documentary Collection makes international trade operations more flexible, especially in cases when the seller does not want to deliver goods to the buyer on "open account" basis, but due to a long-term stable business relationship between the parties, there is no need for security provided by a Letter of Credit or payment guarantee making Documentary collection suitable to the seller. Again this holds good if, the seller has no doubts about the buyer's ability to meet its payment obligations, if the political and economic situation in the buyer's country is stable and if there are no foreign exchange restrictions in the seller's country. Documentary collection is convenient for the buyer because there is no need for an advance payment as payment for goods can be made when shipping documents have been received, in cases of documents released against acceptance the buyer has the possibility to sell the goods first and afterwards make payment to the seller. Documentary Collection assures the seller that the shipping documents will be released to the buyer only upon payment or acceptance of a Bill of Exchange.

Factoring

Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs. Forfeiting is a factoring arrangement used in international trade finance by exporters who wish to sell their receivables to a forfeiter. Factoring is commonly referred to as accounts receivable factoring, invoice factoring, and sometimes accounts receivable financing. Accounts receivable financing is a term more accurately used to describe a form of asset based lending against accounts receivable. Invoice factoring is an easy and flexible way to ensure finances.

Factoring is not the same as invoice discounting (which is called an "Assignment of Accounts Receivable" in American accounting – as propagated by FASB within GAAP). Factoring is the sale of receivables, whereas invoice discounting ("assignment of accounts receivable" in American accounting) is a borrowing that involves the use of the accounts receivable assets as collateral for the loan. However, in some other markets, such as the UK, invoice discounting is considered to be a form of factoring, involving the "assignment of receivables", that is included in official factoring statistics. It is therefore also not considered to be borrowing in the UK. In the UK the arrangement is usually confidential in that the debtor is not notified of the assignment of the receivable and the seller of the receivable collects the debt on behalf of the factor. In the UK, the main difference between factoring and invoice discounting is confidentiality. A factor is therefore more concerned with the credit-worthiness of the company's customers. The factoring transaction is often structured as a purchase of a financial asset, namely the accounts receivable. A non-recourse factor assumes the "credit risk" that an account will not collect due solely to the financial inability of account debtor to pay. In the United States, if the factor does not assume the credit risk on the purchased accounts, in most cases a court will recharacterize the transaction as a secured loan.

There are three parties directly involved: the factor who purchases the receivable, the one who sells the receivable, and the debtor who has a financial liability that requires him or her to make a payment to the owner of the invoice. The receivable , usually associated with an invoice for work performed or goods sold, is essentially a financial asset that gives the owner of the receivable the legal right to collect money from the debtor whose financial liability directly corresponds to the receivable asset. The seller sells the receivables at a discount to the third party i.e. the factor a specialized financial organization to obtain cash. This process is sometimes used in manufacturing industries when the immediate need for raw material outstrips their available cash and ability to purchase "on account". Generally, both invoice discounting and factoring are used by businesses to ensure they have the immediate cash flow necessary to meet their current and immediate obligations.

The sale of the receivable transfers ownership of the receivable to the factor, indicating the factor obtains all of the rights associated with the receivables. Accordingly, the receivable becomes the factor's asset, and the factor obtains the right to receive the payments made by the debtor for the invoice amount, and is free to pledge or exchange the receivable asset without unreasonable constraints or restrictions. Usually, the account debtor is notified of the sale of the receivable, and the factor bills the debtor and makes all collections; however, non-notification factoring, where the client (seller) collects the accounts sold to the factor, as agent of the factor, also occurs. In the UK the arrangement is usually confidential in that the debtor is not notified of the assignment of the receivable and the seller of the receivable collects the debt on behalf of the factor. If the factoring transfers the receivable "without recourse", the factor (purchaser of the receivable) must bear the loss if the account debtor does not pay the invoice amount. Also, if the factoring transfers the receivable "with recourse", the factor has the right to collect the unpaid invoice amount from the transferor (seller). However, any merchandise returns that may diminish the invoice amount that is collectible from the accounts receivable are typically the responsibility of the seller and the factor will typically hold back paying the seller for a portion of the receivable being sold (the "factor's holdback receivable") in order to cover the merchandise returns associated with the factored receivables until the privilege to return the merchandise expires.

There are four principal parts to the factoring transaction, all of which are recorded separately by an accountant who is responsible for recording the factoring transaction:

1. the "fee" paid to the factor,
2. the Interest Expense paid to the factor for the advance of money,
3. the "bad debt expense" associated with portion of the receivables that the seller expects will remain unpaid and uncollectable,
4. the "factor's holdback receivable" amount to cover merchandise returns, and (e) any additional "loss" or "gain" the seller must attribute to the sale of the receivables. Sometimes the factor's charges paid by the seller (the factor's "client") covers a discount fee, additional credit risk the factor must assume, and other services provided. The factor's overall profit is the difference between the price it paid for the invoice and the money received from the debtor, less the amount lost due to non-payment.

Non-recourse factoring is not a loan. When a lender decides to extend credit to a company based on assets, cash flows, and credit history, the borrower must recognize a liability to the lender, and the lender recognizes the borrower's promise to repay the loan as an asset. Factoring without recourse is a sale of a financial asset (the receivable), in which the factor assumes ownership of the asset and all of the risks associated with it, and the seller relinquishes any title to the asset sold. An example of factoring is the credit card. Factoring is like a credit card where the bank (factor) is buying the debt of the customer without recourse to the seller; if the buyer doesn't pay the amount to the seller the bank cannot claim the money from the seller or the merchant, just as the bank in this case can only claim the money from the debt issuer.

When a company decides to factors account receivables invoices to a principles factors or broker, it needs to understand the risks and rewards involved with factoring. Amount of funding can vary depending on the specific accounts receivables, debtor and industry that factoring occurs in. Factors can limit and restrict funding in such occasions where the debtor is found not credit worthy, or the invoice amount represents too big of a portion of the business' annual income. Another area of concern is when the cost of invoice factoring is calculated. It's a compound of an administration charge and interest earned overtime as the debtor takes time to repay the original invoice. There are major industries which stand out in the factoring industry which are:

1. Distribution 2. Retail 3. Manufacturing 4. Transportation 5. Services 6. Construction

However, most businesses can apply invoice factoring successfully to their funding model.

Treatment Under GAAP

In the United States, under the Generally Accepted Accounting Principles (GAAP), receivables are considered sold, under FASB ASC 860-10, when the buyer has "no recourse". Moreover, to treat the transaction as a sale under GAAP, the seller's monetary liability under any "recourse" provision must be readily estimated at the time of the sale. Otherwise, the financial transaction is treated as a secured loan, with the receivables used as collateral.

When a nonrecourse transaction takes place, the accounts receivable balance is removed from the statement of financial position. The corresponding debits include the expense recorded on the income statement and the proceeds received from the factor.

Suppliers will often be more apt to offer trade credit when a business can show a comprehensive financial plan that details out why credit is necessary to support the venture.

Terms for this form of financing can vary wildly, and the cost of it can be very high. For example, let's say that a supplier has offered a two percent cash discount if an invoice is paid within 10 days and a net date of 30 days. This means that if you choose to not pay within ten days, you are forfeiting the two percent, and you have 20 more days to use the money. If this is annualized, this money is costing you 36% of the total cost of the products that you're purchasing then 360 (20 days = 18 times per years with no discount; 18 (2 percent = 36 percent discount missed).

Suppliers that offer trade credit typically will tack on late payment penalties if one doesn't pay within the agreed upon timeframe. These can add up significantly, too. Often, these fees run between one and two percent per month. This can add up to quite a bit if one can't pay for an extended period of time.

Trade credit can be a big help for businesses that are in growth mode, but it definitely requires diligence and careful planning to prevent racking up late fees or just losing money by forfeiting cash discounts. While it's smart to take advantage of trade credit opportunities, it's also a good idea to evaluate other forms of financing that can work with it or as an alternative.

Web-based lenders that offer non-traditional types of funding may also be an option. For example, Kabbage enables online businesses to apply for a line of credit and get approved in minutes. Money is available 24/7, and there's no cost for applying. Many online business owners find that a combination of this type of financing along with trade credit can be a particularly flexible, convenient solution for having enough capital on hand to take advantage of vendor deals while keeping enough inventory on hand to fulfill an increasing amount of orders.

Trade credit can be a business owner's friend, particularly when it's used in conjunction with other types of financing. By weighing risks, opportunities, and options available, an online business owner can create a powerful financing solution that supports long-term growth.

Thus, the efficiency of trade credit products lies on the strategic use made by businesses to avail the benefits of the same.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# Issues of Trade Credit in International scenario

Chapter 3

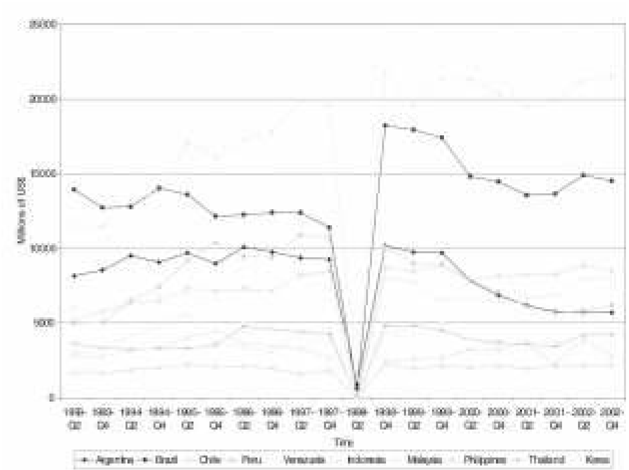
# Issues of Trade Credit in International scenario

Trade finance has played a very supplementary role as a credit enhancer to businesses especially in a global value chain where in trade has a distinct place. However, trade credit has not achieved a pivotal role which it could have, due to the various issues involved in global trade, the prominent being the global financial crisis. In this section we understand these issues in trade credit in reference to the global trade environment. The expansion of trade depends on reliable, adequate, and cost-effective sources of financing, both long-term (for capital investment needed to produce tradable goods and services) and short-term, in particular trade finance. The latter is the basis on which the large majority of world trade operates, as there is generally a time-lag between when goods are produced, then shipped and finally when payment is received. Trade-finance can provide credit, generally up to 180-days, and enterprises in order to fill this gap , attempt to have cash transactions , but to a smaller extent in many developing and least-developed countries. Short-term credit/trade finance has been associated with the expansion of international trade in the past century, and has in general been considered as a routine operation, providing fluidity and security to the movement of goods and services. Short-term finance is the true life-line of international trade.

Financial Crises and Trade Finance In Periods Of Instability

Financial crisis is one of the main issues in trade credit which creates an instability in the payment mechanism. Several episodes of financial crisis in the past like the international financial crisis in the 1990s, affected mainly emerging market economies. While each crisis has its own causes and characteristics; to some extent, the crises that occurred in 1997-98 reflected a general movement of disinvestment out of emerging market economies. The threat of contagion among borrowers also created serious problems for international lenders providing various forms of short, medium and long term credit, and together this took on proportions of international systemic crisis in the late-1990s. It is generally acknowledged that capital account instability played a much more significant role during this period than in the more traditional current account/balance-of payments crises of the 1970s and 1980s, which were linked to uncontrolled spending, high inflation, and excessive public debt. Financial sector fragility and inadequate banking supervision in the crisis-hit countries, in combination with the role of highly leveraged financial institutions, hedge funds and off-balance sheet operations of some institutional investors, and lack of prudential control over their activities, have been the main contributing factors. "Herd" behavior on the part of foreign capital is felt by many to explain why the retreat turned into a rout in some of the crisis-hit countries, where inadequate information, particularly about the level of foreign exchange reserves, made an objective evaluation of the situation more difficult. Internal weaknesses outside the financial sector are viewed by many as having reduced the defenses of the crisis-hit economies to external shocks. Macroeconomic imbalances do not seem to have been the main factor behind the crisis in South East Asia (IMF (1998), WTO (1999)). More important are the implications, both macroeconomic and for international trade. There are two implications that have drawn particular attention from the Working Group on Trade, Debt and Finance: - first, the large swings in exchange rates which have exacerbated the fundamental weaknesses described above (financial fragility, external vulnerability, and poor governance). In particular they created a vicious circle of: depreciation of currencies bringing more financial institutions and their customers into insolvency, and further weakening confidence fuelling more capital , second, the scarcity of short-term trade-financing facilities (in particular the opening of L/Cs and subsequent confirmation). "Cross border" international trade finance for imports became a particular problem at the peak of the crisis in Indonesia, where international banks reportedly refused to confirm or underwrite L/Cs opened by local banks because of a general loss of confidence in the local banking system. Given the high import content of exports (over 40 per cent in the manufacturing sector), Indonesia's growth of exports was seriously affected by the difficulty of financing imported raw materials, spare parts and capital equipment used in its export sectors The financing of exports became an issue for enterprises which bear the exchange rate risk or the risk of non-payment from their clients. Spillovers through trade links exist essentially at bilateral or regional level; with high levels of bilateral trade, a financial crisis will negatively affect all other trading partners through loss of competitiveness or fall in demand. Indonesia was not the only country caught up in this situation. In Thailand, Korea, Pakistan, Argentina and other emerging economies in the late 1990's and early 2000's, liquidity and solvency problems encountered by the local banking systems made it difficult for local producers to get pre- and post shipment finance, open L/Cs, obtain advance payment bonds and other forms of "domestic" trade finance. Despite the scarcity of foreign currency and of liquidity in local markets, standard theory would indicate that solvable demand for credit emanating from companies with good credit rating should meet supply at a higher price. In periods of extreme crisis, however, this supply simply did not exist in certain countries, raising suspicions of market failure. In light of a general loss of confidence in a local banking system, international banks forced up confirmation fees or inter bank loan margins, and reduced or cancelled "bank limits" as well as "country limits". In Indonesia, for example, the total value of trade finance bank limits fell from $6 billion, from 400 international banks, to some $1.6 billion, from 50 banks After the crisis, some local banks still suffer from illiquidity/insolvency, or do not feel adequately equipped to assess the creditworthiness of importer and exporter customers. International banks are likely to have consolidated their exposure to risky markets, and are unwilling to take renewed risks by confirming L/Cs or extending other forms of credit to their correspondent bank relations in those markets.

**Chart 1: Stocks of total trade finance in selected East Asian and Latin American countries**



The above Graph traces the stocks of total trade finance (both bank and non-bank finance) in a number of East Asian and Latin American countries. It shows not only the sharp fall in the total stocks of trade finance in June 1998, but also that for some countries the stock of outstanding short-term credit lines recovered after the crisis, while for some others it has not. However, one should exercise care in interpreting this graph as showing that the availability of trade finance recovered at least in some countries, since it may simply reflect the fact that, in absence of a clear system of sovereign debt restructuring, credit lines had to be rolled over by banks which implies an increase in the cost of borrowing for the countries concerned. Thus, while in fact no new credit lines were available, the rolling over of outstanding credits also increases total stocks. In other countries, such as Indonesia and Argentina, both local and international banks have been unwilling to immediately roll-over existing lines of trade-finance, without strong guarantees that they will be repaid at a given maturity, i.e. without a wider agreement with debtors through a process of restructuring.

It has been indicated through a research that small firms that use no credit are significantly smaller, more profitable, more liquid, and have better credit quality; yet they hold fewer tangible assets. On the other hand, those that use credit are larger, and the amount of credit used as a percentage of assets is positively related to the firm's liquidity. In addition, three-fifths of the small firms that use credit, use trade credit. A survey of multinational buyers (i.e. lead-firms and higher-tier supplier firms in global value chains) indicated that the drop in orders may be more a function of "new credit bottlenecks" than declining final demand per se. The slowdown in trade credit provision has come as a result of more stringent bank credit and capital allocation criteria, growing distrust between international banking borrowers' invoice and payment systems, and a drying up of the secondary market for trade financing instruments. A trade credit crunch will put a more severe damper on the volume of international trade when such trade is organized in global value chains. There are two reasons for this, one, a bottleneck due to lack of credit in one part of the chain can reduce trade for the entire chain as supply chains have produced undesirable side effects. Exporters in international supply chains are better shielded from financial turmoil because they have access to credit from buyers. However, with their own access to finance drying up, global buyers will become more restrictive in providing finance along their supply chains. Second, global value chains are potentially a channel for the rapid transmission of financial shocks, in particular through credit markets, which can have a negative international "cascade effect" as the denial of credit to importers in one country lead to credit problems for sellers in others, reducing their access to credit, affecting in turn their ability to import, etc. This is a vicious cycle between the real and the financial sides of the economy. The implication is that the decline in world trade is greater when the credit crunch that occurs within a production system organized through global value chains. For this reason, the G20 provision of $250 billion to support trade finance over the next two years is an important step in easing the financial side of the trade collapse. The slowdown in trade credit provision has come as a result of more stringent bank credit and capital allocation criteria and growing distrust between international banking counterparts who must cooperate in the provision of trade credit, more stringent requirements on in the Indian context . Firms attempt to increase sales and lower finished goods inventories by offering trade credit both on a gross and net basis. When inventories of finished goods and semi finished goods and raw materials rise, firms tend to postpone payments to their supplier and this shows up on their books of accounts as higher accounts payable. This is likely to help firms tide over negative shocks to sales. Thus trade credit in general can be seen to arise as a financial response to variable demand for their finished goods. Highly profitable firms are found to both give (on both net and gross basis) and receive less trade credit. There could be many underlying results for this finding. Firstly more profitable firms may not face a major problem with respect to variability of demand for their product. The need to offer trade credit for inventory management is thus smaller. Moreover the need to accept trade credit for such firms would also be lower, as inventories would rarely he high. Secondly, profitable but finance constrained firms would prefer not to offer trade credit. The fact that the coefficients of profitability are negative, price discrimination does not seem to be a motive for the existence of trade credit in India.Firm's holdings of liquid assets have a positive influence on accounts receivable and accounts payable and net trade credit. Firms with greater access to bank credit offer less trade credit to their customers. Firms with more access to bank funds do not pass them on to their buyers as accounts receivable. On the other hand, firms with higher bank loans receive more trade credit. The empirical results on the determinants of trade credit in India are very different from those for advanced countries.

In context to German economy, breakdown of payments on account by economic sector demonstrates that trade credit represent a special financing instrument that is commonly used in certain sectors with a prolonged production period and to-order fabrication. The stock of supplier receivables, which as an average is just over €57 billion higher than the corresponding liabilities, is due primarily to German industry's strong focus on exports. This is because, particularly for deliveries abroad, it is usual to grant considerably longer payment periods than in Germany. To an extent, however, these high supplier receivables are also the result of overdue payments and so indicate that non-resident customers' payment behavior is poorer . This is probably due, amongst other things, to the lower status attributed to creditor protection in the legal systems of those countries. Commercial enterprises with their high turnover of goods specifically use trade credits to finance their stocks, and then settle their in- voices with the sales proceeds that their stocks generate. In this way they are able to finance very large holdings of current assets with comparatively little own funds. Retailers in particular do not need to offer nearly as much supplier credit as the corresponding liabilities they are able to use. Thus, they benefit most from this form of corporate financing. In contrast, wholesale enterprises and providers of business related services tend to be net creditors, as they grant their buyers generous payment periods while they themselves take out less credit with their suppliers. It is observed that small and medium-sized enterprises (SMEs) in Germany are not disadvantaged with regard to supplier credit whereas mainly medium-sized German enterprises have the largest share of supplier receivables in relation to total assets (18.1%) – and not micro-enterprises (16.9%) –the latter have the highest supplier liability ratio in their annual financial statements. Large enterprises usually generate relatively high income and cash flows, and are more likely to be interested in receiving discounts rather than long payment periods in view of their ample liquidity and their professional debtor management.

Trade credit is an important source of funding for businesses in Australia, particularly in the unlisted sector. Although most unlisted businesses use trade credit to some degree, the extent of its use is influenced by both the nature and size of businesses. Industries that carry extensive inventories and are providers of intermediate goods tend to use and supply more trade credit. Likewise, large unlisted businesses typically have a higher proportion of trade credit to total assets than smaller unlisted businesses, possibly because the latter tend to have weaker bargaining power and are perceived to be riskier than larger businesses. Businesses generally appear to be consistently repaying trade credit well beyond the due date, suggesting that trade creditors tend not to enforce late payment penalties against their trading partners.

Given the funding that trade credit provides, its use has implications for understanding both the transmission of monetary policy to the business sector and the financial health of businesses over the credit cycle. For example, an increase in interest rates should make bank credit more expensive and result in businesses scaling back their borrowing. However, if businesses have ready access to funds outside the financial systems that do not incur the payment of interest, such as trade credit, the reduction in total funding may be less than it would be otherwise.

A growing literature finds that financial market imperfections significantly affect international trade. Foley and Manova (2015) provide a detailed overview of this work. The evidence indicates that financial frictions restrict firms' entry into exporting, the scale of their operations conditional on exporting, and their position in global value chains. These distortions impede aggregate trade, especially during financial crises. Moreover, credit constraints disrupt cross-border trade significantly more than general production because of the larger financing needs of foreign transactions: Overall, 75-80% of the total reduction in trade due to financial sector underdevelopment is above and beyond any associated decline in total output. One third of the trade-specific effect can be attributed to limited firm entry into exporting, while two thirds reflect reduced firm-level exports (Manova 2013).

Information asymmetries arising from deregulation, then, could make the cost of bank finance prohibitively high, and finance-based theories of trade credit predict that firms would seek to lower information costs. Ostensibly, these costs may be reduced by exploiting old ties and information about former trading partners. Evidence from Russia shows that firms entering into these relationships are neither state-owned enterprises (SOEs) nor former state enterprises (FSEs).New firms are obtaining trade finance, further, firms using trade finance seem to be more successful at obtaining bank loans. Thus, trade credit may diminish information costs through an alternative mechanism. A motive for formally capturing the intuition behind the link between bank and trade finance is that finance-based explanations of trade finance are inadequate to explain what appears to be an ulterior motive for Russian firms to obtain trade credit: to use trade finance as a stepping-stone to access bank credit. Hence, trade finance is only an intermediate, rather than final, goal of a firm in need of external finance. At the start of transition, the existence of subsidies impaired financial intermediary.

At the start of transition, the existence of subsidies impaired financial intermediaries' ability to distinguish between profit-maximizing behavior and nonprofit-maximizing behavior. The availability of subsidies and inter-enterprise credit regardless of firm performance provided no incentive to maximize profits. In the later transition period, this signal has been endowed with value by the reduction in subsidies and the decentralization of credit markets.

Also,Basel III is expected to have a negative impact on trade finance . Standard Chartered estimates that the implementation bank capital requirements under Basel III could raise the average cost of trade finance by up to 40%, thereby reducing its lending capacity by 6%. Such a reduction in trade finance could potentially shrink the volume of world trade by 2% and global GDP by 0.5%. In a recent survey conducted by the ADB, 79% of respondents indicated that Basel regulatory requirements were a significant obstacle limiting trade finance. In April 2013, Europe relaxed Basel III trade finance rules but other economies have not yet followed suit. Empirical evidence shows that: Access to trade finance enhances the probability of becoming an exporter. Economies in which trade finance is either more difficult or more expensive to obtain tend to export less Enhancing trade finance.

Thus , to summarize the main issues in trade credit are economic distresses spread across the countries between which trade occurs. Trade credit has been an important instrument to provide for working capital finance in the developed world where economic distress is sparse.

# Relevance of Trade Credit in a Global Value Chain

Chapter 4

# Relevance of Trade Credit in a Global Value Chain

Trade credit is an integrated part of a supply contract and has intrinsic connections with supply chain contracting and inventory management. It is demonstrated that with demand uncertainty, trade credit enhances supply chain efficiency by serving as a risk-sharing mechanism. Two forces determine the optimal trade credit terms: the sales motive (increasing sales through risk-sharing) and the financing motive (minimizing costs of financial distress through financial diversification that is, employing multiple financing sources). Common wisdom in operations suggests demand uncertainty and early commitment to order quantities leave the retailer with significant inventory risks, hence forcing the retailer to order less than would be optimal for the supply chain. Trade credit influences supply chain efficiency through two separate effects. First, similar to many other channel coordination mechanisms, trade credit allows the retailer to share inventory risks with the supplier, hence inducing a higher order quantity from the retailer. This effect, which we call the sales motive, incentivizes the supplier to offer cheap trade credit. Second, through the financing motive, trade credit transfers some of the distress costs from the retailer to the supplier, allowing the former to further increase the order quantity. Unlike the sales motive, the financing motive is a double-edged sword. Although it encourages the supplier to offer trade credit to further boost sales, it also incentivizes the supplier to limit the amount of trade credit by adjusting its price. Combined, these two effects explain how the supplier lends to the retailer, but also rationalize why the price of trade credit is dispersed.

Trade credit as a supply chain mechanism improves supply chain efficiency and provides more flexibility in profit allocation. Using the integrated chain and the decentralized chain with price-only contract as benchmarks, one can identify the negative effect of financial constraints and distress costs on supply chains. When receiving both trade credit and a bank loan, the retailer faces two creditors. Moreover, when providing trade credit, the supplier is exposed to demand risks as well. If the business has sufficient cash, it can provide the trade credit out of its own pocket. However, with limited cash, the supplier may use an external source to finance production and provide trade credit to the retailer. Unlike the retailer, the supplier has an alternative, i.e upon the delivery of the goods, instead of receiving cash, the supplier receives accounts receivable with an amount from the retailer. As a common means to manage accounts receivable, the supplier might sell a portion of the accounts receivable to a third-party factor for immediate cash (factoring). Whether the supplier chooses to use a bank loan or factoring, the amount borrowed or factored, together with the cash the supplier has, he should be sufficient to cover the total production cost. As an integrated part of a supply chain contract, trade credit plays a distinct role in a supply chain in managing operational and financial risks among companies in supply chains. On the operational side, demand uncertainty and early commitment results in suboptimal inventory decisions in supply chains. As a contingent claim, trade credit allows the supplier to share part of the inventory risks which the retailer otherwise bears alone, hence inducing higher order quantities from the retailer. On the financial side, costs of financial distress, which play an important role in capital structure, limit the retailer's ability to use external sources to finance inventory. Trade credit, together with other financing contracts, allocates costs of financial distress among different parties more efficiently. Due to its extensive use in practice, trade credit might be the most common risk-sharing mechanism in supply chains. However, information related issues are unavoidable in supply chain contracts. Introducing information asymmetry can influence the effectiveness of trade credit in different directions. On the one hand, information asymmetry may weaken the risk-sharing role of trade credit, as it does to other supply chain contracts. However, due to its simple form, trade credit may suffer less from information asymmetry than other contracts. On the other hand, trade credit provides a cash flow that is (partially) independent of the existing information flow (orders) and material flow (physical goods delivery) within supply chains. Therefore, it may alleviate some well-documented problems in supply chains. For example, by receiving trade credit payments, the upstream company can infer more about the downstream company's sales, thereby reducing the bullwhip effect .

In context to operational perspective, large public retailers in North America, we find that accounts payable alone amounts to approximately one sixth of total assets and one third of total liabilities. When examining individual firms, we find that, for example,Wal-Mart had $28.8 billion accounts payable in its balance sheet on January 31, 2009, amounting to 75 percent of its total inventory ($34.5 billion). Circuit City, the consumer electronic retailer that filed for bankruptcy in November 2008,3 had trade creditors out of its 50 largest unsecured creditors. The three largest trade creditors of Circuit City (Hewlett-Packard, Samsung, and Sony) held total claims of $284 million, accounting for 12 percent of its total liabilities ($2.32 billion). Because of its wide usage, trade credit has long been studied in the areas of economics, finance, and accounting. Researchers have proposed many theoretical explanations for trade credit in various settings; however, despite its intrinsic connection to business operations, especially supply chain contracting and inventory management, trade credit has rarely been examined from an operational perspective. Common wisdom in operations suggests demand uncertainty and early commitment to order quantities leave the retailer with significant inventory risks, hence forcing the retailer to order less than would be optimal for the supply chain. As a type of inter-firm contracts, trade credit has unique advantages in mitigating this problem: not only are the amount and timing of trade credit closely associated with purchase and inventory decisions, but the repayment of trade credit is contingent on the demand realization, similar to many risk-sharing mechanisms in channel coordination.

Therefore, a reasonable conjecture is trade credit is extensively used, at least partially, to reduce the widespread inefficiency in supply chains.

Thus we understand how trade credit forms a distinct and integral part of the global value chain and not only helps as an important source of finance but also as a stable source of finance if the supply chain loop remains in harmony even in signs of distress.

# What The Stakeholders have to Say.......

Chapter 5

# What The Stakeholders have to Say.......

## Macro view

**Mr. Ritesh Singh**
Group Chief Economist
Raymond Ltd.

India's merchandise exports have been declining for the last 15 months in a row. SMEs account for 40% of India's merchandise exports, hence they're severely affected. On the other hand, Indian govt. is phasing out export incentives/subsidies even if that helps exporters especially SMEs in being price competitive as access to credit at competitive interest rate remains their key concern.

Broadly defined, export credit is any kind of direct and indirect financial support to promote exports. It has proved to help a country's exports.  China is the world's top exporter and no surprise it's also the top export credit provider at $ 45.5 billion compared to just $ 10 billion by Brazil, India and Russia taken together. If one adds indirect export credit i.e. trade aid, project finance and other indirect forms of export finance...this figure would cross $110 billion.

Let us take some Indian example: one of the reasons why India's power manufacturers importing Chinese power equipments is because it's bundled with cheaper financing terms. India decided to give bullet train contract to Japan...and one of the factors that decided in favor of Japan is finance with 0.5% interest rate. India's EXIM bank too provides Lines of Credit....that indirectly helps India's exports to African countries....with payment risks.

This panel discussion will focus on how trade credit can help India's SMEs sector in pushing India's exports and what are the options/instruments available that can help SME-exporters. How to minimize payment related risks when exporting to markets of Africa. It is to be noted that going forward direct export credit instruments will face difficulties at WTO and hence there is a need to devise non-specific export credit instruments that can't be challenged by WTO member countries. However, cheaper credit alone will not be enough to push India's exports...other things including a protective use of trade policy is also needed among others as well as an improved trade facilitation infrastructure...only then SMEs can integrate with regional and global GVCs.

**Mr. Suhas Thosar**
Trade Finance consultant

Trade Finance issues and MSME

**Exports**

• Lack of KYC
• Lack of country risk assessment
• Acceptance of unrealistic terms such as 50 percent advance and balance upon receipt of goods( The balance payment is never received)
• Not hedging exposure taking into consideration the costing
• Not understanding use of proper Incoterms . Using Incoterms FOB( actually it is FCA) thereby giving control of material to the buyer's nominated shipping agent
• Consigning material directly to the buyer. e.g. Showing consignee as the buyer ( use of straight bill of lading )
• Total ignorance of Exchange Control guidelines e.g/1 Despatching of original export documents directly to the buyer. 2 Retaining original documents with self without any justifiable reason.
• Not understanding LC transactions

**Imports**

• Remitting advance payment without KYC
• Not obtaining credit report on the seller
• Not calling for independent agency's inspection report about quantity/quality of material
• Not understanding LC transactions

Solutions
Exports as well as Imports
• Proper training is the only solution. There is no training institute to take care of practical difficulties. The major focus of training is about theory. The training must include case studies and must be ongoing . Attending of one or two sessions is not adequate.
• There is a great necessity for training of bankers as well as the MSMEs with regard to UCP 600
• Hiring of knowledgeable manpower.

# Micro view

**What is trade credit and why does it exist Globally?.**

**Mr. Arun Sehgal**
Chairman &
Managing Director
Chempro Ltd.

When input suppliers deliver goods to their customers, they often do not require to be paid immediately. Instead, suppliers offer credit terms that allow the buyers to delay the payment. This practice is called trade credit.Trade credit transactions normally involve short-term (e.g. thirty to sixty days) delayed payment of purchases of intermediate goods or services. Through delayed payment, trade credit suppliers are effectively funding their clients with short-term debt. However, trade credit has three main differences with respect to other types of corporate debt. First, suppliers lend 'in kind'; they seldom lend cash. Second, in contrast with bonds or loans, trade credit is frequently not subject to specific, formal contracts between the lender and the borrower. Finally, trade credit is issued by non-financial firms.There are two main issues in international trade. One, credibility of supplier, second, just in time inventory for the buyer.In case of first time transaction, trade credit or suppliers' credit creates a credibility about quality of deliveries. The buyer has more comfort levels buying goods on credit because he has no fear about making any loss on transaction. In this case, buyer needs to have very high credit worthiness. An alternate case is where the supplier has high credibility. In such a case, buyer does not mind paying advance cash for the transaction and normally asks for a very attractive price. In both above situations, trade credit is creating value in the global supply chain. Suppliers credit facilitates buying goods just in time thereby reducing inventory carrying costs. Advance payments usually are made against an offer of cash discounts which again creates value in the global supply chain.

**Dr. Sunjay Koyande**
Chairman &
Managing Director
CCRT Labs Ltd.

SMEs play a vital role for the growth of Indian economy by contributing 48 percent of industrial output, 41 percent of exports, employing 65.9 million People, creating 2 million jobs and produce more than 8560 quality products for the Indian and international markets.

***Globally, about $74 trillion of business is sold on credit terms.*** Global trade finance revenues were more than $15 billion in 2013 and are expected to grow by 8% per annum until 2020.

Small and medium sized enterprises (SMEs) are a major, yet often overlooked driver of the world economy. They account for more than half of the world's gross domestic product (GDP) and employ almost two-thirds of the global work force.
However, around the globe, SMEs often have one major pain point – dealing with their finances and ensuring appropriate funding. As reported by the International Financial Corporation (IFC), a "funding gap" of more than $2 trillion exists for small businesses in emerging markets alone. **Trade credit insurers cover their clients against losses from trading with companies that go bankrupt**. Insurers have a duty to protect customers through the prompt payment of claims and by enabling them to manage risks. They do not wish to stop covering trade with

certain risky companies as that withdraws protection from their clients. At the same time insurers must also at all costs maintain their own financial health.

**Investment-grade corporate bonds have been one of the most sought-after asset classes as a record number of investors have been attracted to their relatively high yields and conservative risk characteristics**. Bond issuance is also continuing apace. With bank loans harder to come by, bonds are becoming the funding vehicle of choice for a broader array of companies.

With the significant share, in terms of industrial enterprises, held by SMEs, funding in any form is vital for the growth of an enterprise. With almost 40% contribution in Indian Cross border trade, SMEs play a significant role in meeting the Govt's targeted growth and maintenance of balance of trade. India still continues to be an import led economy at different levels of industry segments.

**Mr. Saurabh Jain**
Head Business Banking Products, Private & Business Clients - India
Deutsche Bank

Over the years, with the boost in cross border trade across countries, SMEs have access and better understanding of appropriate funding options. Challenges in terms of lack of information lead to restricted credit availability to SMEs. Trade credit specifically has emerged as an important tool to aide importers' working capital needs. Challenges still remain in availing suitable working capital accessibility to Indian SMEs in global value chain. However, banks and Financial institutions have shown progress in making suitable products available to SMEs at competitive pricing.

**Mr. Anurag Mishra**
Regional Lead- Business Development & Global Trade Finance Program International Finance Corporation

SMEs play a pivotal role in both developed and developing economies. SMEs are essential for greater economic growth and social development as try bring inclusive and broad-based integration. SMEs face borrowing challenges as they get unfavourable terms and shorter duration financing compared to their actual requirement. There is constraint as far as bank credit is concerned - however SMEs can now tap alternative financing sources like trade loans, suppliers credit, buyers credit, receivable financing ( supply-chain financing) , factoring, cash flow based financing, etc.

SMEs have the opportunity to play a crucial role both as indigenous and foreign-based firms in various forms as they are the essential component for industrial growth. Local firms and SMEs are participating in production networks, particularly in the electronics, machinery, ICT, automobile and service industries space - producing not only parts and components but also industrial equipment. This economic integration provides business opportunities to not only participate in production networks but also to capture expanded domestic and external markets.

Credit related challenges, most financial support measures for SMEs have limited outreach and that too at high cost. Higher transaction costs, perceived risk, lack of transparency and lack of bank expertise in the evaluation of SME loans render it unprofitable for commercial banks to focus on such enterprises as their main debt clientele. Also, lack of business plan leads to stringent bank demands for collaterals. Lack of credit-rating, poor financial reporting, information disclosure are other issue that have lead to SMEs facing huge gap in financing.

Alternate sources of financing like the trade credit play an important role as they bring in much required relief to SMEs and bridge the gap till there SMEs are able to build a history, understand banking requirements and over a period of time get ready to meet stringent banking requirements for term loan, working capital funding etc.

# Conclusions and Recommendations

**Conclusions**

- One-fifth of small firms do not use credit; one-fifth use only trade credit; another one-fifth use bank credit (bank); while two-fifths use both bank and trade credit.
- Unleveraged firms are less likely to be organized as corporations, are younger, and have less desirable credit scores.
- Small businesses using trade credit are larger, more liquid, of worse credit quality, and are less likely to be in the services industry.
- Evidence strongly suggests that they are complements as two-fifths of small firms consistently use both types of credit simultaneously.
- SMEs are disproportionally affected
- SMEs have not been able to benefit from the abundant global liquidity and low cost of trade financing.
- SMEs in developing economies – given their opacity, lack of collateral and audited financial statements, are considered as high risk by banks
- SMEs in some developing APEC economies, such as VietNam and Russia, are experiencing difficulties in obtaining trade finance
- Demand for the ADB's trade finance facilitation program increased strongly in 2012
- Access to trade finance enhances the probability of becoming an exporter
- Economies in which trade finance is either more difficult or more expensive to obtain tend to export less
- Trade debt serves a tripartite role in overcoming capital market imperfections stemming from hidden information. First, between firms it mitigates hidden information problems, because suppliers have privileged information on the business conditions of their partners. Second, for the sake of demonstrating to banks creditworthiness, firms may seek trade debt. Banks, then, are able to lend on the basis of this signal.
- Both the analytical model and empirical evidence lead to the conclusion that an essential role of trade credit is to act as a risk-sharing mechanism and mitigate the mismatch of operational and financial risks among companies in supply chains.

  On the operational side, demand uncertainty and early commitment results in suboptimal inventory decisions in supply chains.

**Recommendations**

- Trade insurance should be guaranteed without any bias to the companies involved. At the same time insurers should maintain their own financial health and not fall back on claims.
- There is a need to devise non-specific export credit instruments that can't be challenged by WTO member countries.
- Protective use of trade policy is needed among others along with improved trade facilitation infrastructure making SMEs can integrate with regional and global GVCs
- Practical ongoing training needs to be imparted in trade credit instruments like Documentary collection and letter of credit etc.
- There is a great necessity for training of bankers as well as the MSMEs with regard to UCP 600 thus having knowledgeable manpower.
- There is an urgent need to formalise the trade credit market and come out with finer products adapting to the changing requirements of this sector.
- Trust factor needs to be strongly built between the stakeholders .
- Insulation against political crisis in this sector should be ensured by the government agencies.

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Zhihong Yu *University of Nottingham, GEP* and *CESifo* This Draft: February 22, 2016

# Programs Schedule

## TRADE CREDIT: Its relevance to Global Value Chains in Context to Indian MSMEs

### 29th April 2016

**Venue:** World Trade Center Mumbai, Centrum, Center 1Building, Cuffe Parade, Mumbai

**SMEs hold about 40% trade in Global value chains and are the ones most affected by the lines of credit available to them. Since inter border trade is committed between the participating stake holders of the GVC network this panel discussion will help us understand the new financial products available in this sector which help funding the production operation through such an arrangement. Modern financial products in the form of international currency loans against purchase orders, letter of credit and bank guarantee are common examples of how trade can help seeking credit and at the same time market for the domestic SMEs part of this GVC network. In this panel discussion an attempt is being made to understand the relevance of trade credit in a GVC network in context to the SMEs.**

| | | |
|---|---|---|
| 10:00 am to 10.30 am | Address by Chief Guest & Release of Knowledge Paper | |
| Session<br><br>10.30 am to 1.30 pm | **Strategies to optimize Trade Finance in context to SMEs in GVC network**<br><br>1. **Mr. Ritesh Singh**, Group Chief Economist,Raymond Ltd. (Moderator)<br><br>2. **Mr. Anurag Mishra**, Regional Head - Global Trade and Short Term Finance, Asia Pacific Region, IFC<br><br>3. **Mr. Arun Sehgal**, CMD, Chempro Ltd<br><br>4. **Dr Sunjay Koyande**, CMD CCRT Labs Ltd<br><br>5. **Mr. Saurabh Jain**, Head Business Banking Products, Private & Business Clients - India Deutsche Bank<br><br>6. **Mr. Utpal Gokhale**, General Manager & Group Head of Corporate Banking Group, EXIM Bank<br><br>7. **Mr. Samarth Mathur**<br>Product Manager, Kotak Mahindra Bank | This session will deliberate upon various issues in trade credit which act as bottlenecks and how the same can be optimized to suit the conditions and made relevant as a credit enhancer. It will also discusses the efficiency of financial products in trade credit |
| 1.45 pm to 2:00 pm | Vote of Thanks | |
| 2.00 pm | Networking Lunch | |

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WTC Mumbai serves as a corollary to India's challenges in the areas of economy and trade, virtually growing beyond the ambit or scope of the government and trade promotion organizations. At the time, there was felt the need of a concept of World Trade Centre at a global level which could create the necessary linkages in various sectors of the economy across countries of the world.

The World Trade Centre addresses the key issues of International Development through educational programmes, research & publications, tenant facilities and an array of trade activities.

The promoters of WTC Mumbai developed the idea and concept of the Centre in a unique tripartite partnership of state, government and the private sector. In due course, WTC Mumbai was registered under the Indian Companies Act, 1956 as a Section 25 not-for-profit company named M. Visvesvarya Industrial Research and Development Centre (MVIRDC). MVIRDC's prime objective is to conduct research and development and its ancillary objective is establishment of WTCs in India and abroad.

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