

# FINANCIAL MECHANISMS SUPPORTING TRADE TRANSACTIONS BETWEEN INDIA AND PAKISTAN

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# Outline

- ▣ Trade Financing – An overview
- ▣ Risks in Trade Financing
- ▣ Trade Financing Products
- ▣ Documentation
- ▣ Challenges
- ▣ Issues in Trade Financing
- ▣ Recommendations

# Trade Financing

- ▣ Trade finance can be described as the science on how to manage money, banks, credit investments and other assets for international trade transactions
- ▣ Trade Finance is more than regular lending. It refers to products and services that assist importers and exporters to fulfill their financing needs
- ▣ Trade finance is a source of working capital for many traders in need of financing to procure, process or manufacture products before sale in future
- ▣ Trade finance is also important for individual traders and firms trading internationally, because it can shape the competitiveness of their contract terms

- ❑ Trade finance is therefore important for any country as it facilitates international trade. As international trade increases, so does the importance of trade finance.
- ❑ Absence of an adequate trade finance infrastructure is, in effect, equivalent to a trade barrier
- ❑ Importers facing difficulties accessing trade finance, have limited chance to offer competitive terms to their suppliers the like of advance payment terms, letters of credit, guarantees of availed bills for example
- ❑ Conversely, exporters with limited supply of trade finance, will have difficulties in penetrating the market because, while importer may prefer to buy on open account, the supplier may not be in a position to accept or offer such terms.

# Major Risk in Trade Finance

- ▣ Transit Risk
- ▣ Exchange Risk
- ▣ Political / Country Risk
- ▣ Economic Risk
- ▣ Environmental Risk
- ▣ Counterparty (Buyers/Sellers) Risk

# Trade Finance Products

- ▣ Cash in Advance
  - Minimal risk to exporter
  - Used where there is political unrest, goods made to order with new unfamiliar customers
- ▣ Commercial letters of credit
  - Reduces credit/default risks with payment certainty from corresponding banks and provide a financing source to exporters
  - Importers are assured of shipment with proper documentation and easy cash recovery if discrepancies.

# Trade Finance Products

- ▣ Drafts – unconditional order in writing to pay
  - clear evidence of financial obligation
  - reduced financing costs
  - provides negotiable and unconditional financial instrument (i.e. May be converted to a banker's acceptance)
- ▣ Consignment – Consignee (importer) attempts to sell goods to a third party; keeps some profit, remits rest to consignor (exporter)
- ▣ Open Account – Credit Sales with greater flexibility and low transaction costs but highly vulnerable to government currency controls.

# Trade Documents

1. Bill of Lading (most important)
2. Commercial Invoice
3. Insurance Certificate
4. Consular Invoice



# Financing Techniques

- ▣ Bankers' Acceptances
  - Creation: drafts accepted
  - Terms: Payable at maturity to holder
- ▣ Discounting
  - Converts exporters' drafts to cash minus interest to maturity and commissions.
  - low cost financing with few fees
  - May be with (exporter still liable) or without recourse (bank takes liability for nonpayment).
- ▣ Factoring
  - Firms sell accounts receivable to another firm known as the factor
  - Non-recourse basis: Factor assumes all payment risk.
  - When used: Occasional exporting and Clients geographically dispersed.
- ▣ Forfeiting
  - discounting at a fixed rate without recourse of medium-term accounts receivable denominated in a fully convertible currency
- ▣ Government Schemes
  - Export Refinance Schemes

# Other Forms of Trade Settlements

- ▣ Barter: direct exchange in kind
- ▣ Counterpurchase: sale/purchase of unrelated goods but with currencies (currency swap)
- ▣ Buyback: repayment of original purchase through sale of a related product.

# Key Challenges

- ▣ Arranging financing:
- ▣ Navigating regulations:
- ▣ Managing counterparty risk: suppliers and customers
- ▣ Controlling and optimizing cash: reducing DSO and extending DPO
- ▣ Accessing expertise: local market knowledge, best practices

# Issues in Trade Finance

- ▣ Trade financing suffered with rigidities in L/C confirmation and delays.
- ▣ The settlements through the Asian Clearing Union add another bureaucratic layer to the existing mechanism
- ▣ In the absence of branches of domestic banks across border, they need to maintain nostro & vostro account in third country in foreign currencies
- ▣ information asymmetry and the lack of awareness among custom officers

# Issues in Trade Finance

- ▣ SME's difficulty in getting started with the financing process and finding capable banks willing to handle their transactions
- ▣ Lack of assistance in logistics and transportation techniques so vital to successful cross-border deals
- ▣ Exporter's perception of onerous collateralization requirements
- ▣ Lack of qualified credit management offices
- ▣ Exporter's perception that finance application procedures are complex and time consuming

# Issues in Trade Finance

- ▣ SME's is general whether importing, exporting or trading are unattractive due to their relatively weak financial conditions
- ▣ The bank's perception that indo-Pakistan trade volumes are small and lacks profit potential
- ▣ Bank's fear with government policies across border
- ▣ Banks' undue reliance on an exporters financial and performance criteria irrespective of the strength of transaction

# Issues in Trade Finance

- ▣ Banks constant anxiety notably amongst its lending officials over the borrowers ability to repay especially in case of Indo-Pakistan trade
- ▣ Banks apprehension in accepting foreign accounts receivable as collateral or comfort from neighboring country
- ▣ Banks failure to develop loan officers familiarity with trade finance across border
- ▣ Banks perception of razor-thin pricing margins in the market

# Recommendations

- ▣ Front line manager in the banking system on both sides of the border need to be trained and make them aware of policies pertinent to India-Pakistan trade
- ▣ 24/7 E-banking solutions
- ▣ Increase Transparency
- ▣ Representative offices of commercial banks
- ▣ Trade in local currencies – Currency swaps