Trade Credit: Issues and prospects

Trade is the engine of the global economy. It allows companies to grow, compete and improve on their products. Trade creates jobs and investments. It increases income levels and reduces poverty. Whether an economy is developing or not, or if it is small or large, trade is of vital importance. Without trade, growth is not possible. Trade allows micro-enterprises to grow into small and medium enterprises and beyond. Access to international markets presents tremendous opportunities for poor countries to trade their way out of poverty. An open trading system helps increase income levels and reduce poverty.

Trade is not without risk. Shipped goods may never arrive; problems can occur with regard to payments. How do you know if a buyer is reliable? How do you enter a new market? Concerns such as these are faced on a daily basis by trading companies. Trade credit insurance is a product designed to assist traders in addressing these and many other concerns. Credit insurance facilitates trade around the world, both for trade within a country as well as for exports. Trade credit insurance offers protection from financial loss when receivables remain unpaid. It is an insurance product, but also much more than that. It is a key financial instrument for exporters and sellers to manage credit risk, helping to prevent the risk of systemic claims. Banks lend more capital against insured receivables; credit insurance contributes to increased sales; it saves on expenses such as credit information, analysis, collection expenses, reducing provisions for bad debt – and, most importantly, protecting exporters' and sellers' balance sheets against the negative impact of credit losses. It helps improve the policyholder's credit standing by improving the credit quality of its receivables. Credit insurance companies partner with their clients and become part of their risk management process. The credit insurer assists clients during the course of their policy in managing trade and risk flows, and minimizing losses. Trade credit insurance is therefore a critically important financial tool for companies and exporters.

Indian exporters are facing constraints 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, he added. As for factoring, availability of credit insurance is an issue. Even when it is available, the costs are high.

Trade credit is a finance cushion though with limited extent to the worth of goods. 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 makes 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.

Following the slowdown and credit crunch globally, insurers are not willing to take the risk, according to GTF, which has an 88% share of the international receivables finance business. With the recent collapse in international trade, credit availability has had its relative impact on SME exporters.
Given the importance of SMEs in job creation, as well as the problems emanating from the chronic trade deficits, the extent to which SME exporters are adversely affected by frictions in the credit markets is an important public policy issue. 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. Small exporting firms are affected more by deterioration in bank financing than are larger exporting firms. In fact, given that we have reason to believe that exporting firms are more sensitive to bank financing compared with firms producing for the domestic market, a program supporting credit to smaller exporting firms may provide the greatest "bang per buck" among focused small business lending guarantee programs when bank financing weakens and the availability of credit is impaired.

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. In this way credit constrained firms avoid having to liquidate assets. Trade credit default chains can serve a useful role in allocating liquidity to credit constrained firms. SMEs increasingly depend on handholding by the banks to meet their credit requirements.

Persistently sluggish industrial growth 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 aiding 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 .However, deterioration of same has led to fall in credit culture making the credit-based segment of the payment system increasingly vulnerable.

In light of the above representation, AIAI feels there is a need to relook at the NPA Norms for MSME and infrastructure projects and also moratorium on earlier loans and interest for 2-3 years to move forward as the industries as a whole is facing liquidity crunch which needs to be addressed on priority, this shall resolve the pending issues and economy shall get impetus for better growth.