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Selected Non – Funded Products and Trade Finance Income among Commercial Banks in Kenya

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ABSTRACT

This study was aimed at determining the effect of selected non-funded products on trade finance income among commercial banks in Kenya. The selected non- funded products investigated in the study included: Guarantees; letters of credit and documentary collections. The research design for the study was descriptive with a target population, hence unit of analysis, comprising of 39 commercial banks in Kenya licensed and regulated by Kenya's Central Bank in the year 2021. The respondents (unit of observation) were 39, representing a trade finance manager from each of the commercial banks. Therefore, the respondents provided data that was analysed using various statistical tools. The study found a substantial association between these products and Trade Finance income using inferential analysis, which included correlation analysis and regression analysis. Piloting of the study was undertaken using 10% of the sample size. These was important in establishing both the validity and reliability of the data collection instruments. The Cronbach alpha scores were above 0.70, hence, giving confidence that the data collection instrument was reliable. The results of the study show that a component of trade finance revenue is affected by the issuance, handling or management of trade finance instruments. The majority of commercial banks' non-funded bank products, which include letters of credit, guarantees, and documentary collections, are classified as trade finance solutions in the study's descriptive analysis. Commercial banks in Kenya are urged to expand their trade finance solutions offerings to electronic trade finance products such as electronic letters of creditand electronic guarantees in order to keep up with international best practices

Key words: Non- funded trade finance income, Guarantees, Letters of Credits, Documentary collections.

BACKGROUND OF THE STUDY

Trade is a key engine of economic development and progress. Kenyan trade accounts for almost two-thirds of the country's gross domestic product (GDP). The country's export and import flows have development ramifications. Exports enable Kenyan businesses to tap into bigger markets and innovate as a result of increased competition, resulting in increased productivity and growth. Imports of consumer items are necessary for consumers, but imports of machinery and other intermediate products enable manufacturing enterprises to increase production and exports, resulting in more jobs (World Bank, 2021).

Commercial banks core intermediation mandate is to receive deposits and issuing interest-bearing loans from and to their customers respectively. Apart from this, banks also earn fees by performing activities that do not rotate around deposits or loans. Non-funded Trade financing is one of such activities where the bank

commits its word to pay upon fulfillment of certain conditions as outlines by the Bank in an undertaking pre-issued by the said bank.The income earned in these cases is fee-based income and popularly stated as Non-Interest Income by commercial banks during their financial reporting (Ng'endo, 2012).

Trade finance involves use of instruments by commercial banks giving its commitment to pay based on given terms and conditions. It is important to note that banks deal with documents in trade finance, which is why the majority of services are specified using document titles to give funding to importers or exporters (Moffett, Stonehill & Eiteman, 2019). As a result, businesses seek trade funding from financial intermediaries such as commercial or development banks, as well as export promotion organizations. Documentary, commercial, or standby letters of credit, promissory notes, bills of exchange, and guarantees are examples of bank-intermediated trade finance that can be given "off-balance sheet".

The provision of credit facilities to institutions engaged in international trade and business is referred to as trade finance (Kahuthu, 2016). Trade Finance is also said to be the financing undertaken to facilitate trade or commerce (Mann, 2018). When bank financing is unavailable, enterprises often opt into inter-firm credit arrangements such as cash-in-advance and open account transactions, according to Malouche (2009). Both systems are fraught with danger, and businesses are compelled to use them due to a lack of alternatives. The specific objective of the study was to investigate the non-funded trade finance products offered by commercial banks in Kenya and their effect on trade finance income among commercial banks in Kenya.

RESEARCH METHODOLOGY

The research design for this study was descriptive and it involved a census sample of the 39 commercial banks that formed the target population for the study. The respondents were trade finance managers from each of the 39 bankslicensed and regulated by Kenya's Central Bank in the year 2021, hence the use of census sampling technique (Kothari, 2014; Mugenda and Mugenda, 2019). Data was collected using closed ended questionnaires that were shared electronically to respondents via google link. These was ideal for the study since it was a purely quantitative study. Closed ended questionnaires were ideal for quantitative data analysis (Saunders, Lewis and Thornhill, 2019)

Table 1.0: Target population and Sampling Frame

Category	Trade finance management employees	Percent
Tier 1 Banks	8	20
Tier 2 Banks	10	26
Tier 3 Banks	21	54
Total	39	100

Source: CBK Bank supervision annual report (2020)

Data was analysed using quantitative tools such as Statistical Package for Social Sciences (SPSS). Ethical considerations of informed consent, voluntary participation, confidentiality, privacy and anonymity were all observed (Cooper and Schidler, 2018; Creswel, 2018).Piloting of the study was undertaken using 10% of the sample size. These was important in establishing both the validity and reliability of the data collection instruments. The Cronbach alpha scores were above 0.70, hence, giving confidence that the data collection instrument was reliable.

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LITERATURE REVIEW

The literature review addresses how the selected non-funded products influence trade finance among commercial banks in Kenya. These selected non-funded products include: guarantees; letters of credit; and documentary collections.

Guarantees and Trade Finance Income

Guarantee or demand guarantee means 'any signed undertaking however named or described, providing for payment on presentation of a complying demand' (ICC URDG 758). The guarantor irreversibly commits to pay the beneficiary amount demanded, up to the maximum amount indicated in the guarantee, upon presentation of a demand that satisfies the provisions of the guarantee. Bid bonds or tender bonds are one of the guarantee products that the bank provides, along with performance, advance payment, retention money, warranty, customs, payment, and counter guarantees (Affaki & Goode, 2011). Guarantees or demand guarantees are issued by a guarantor on behalf of an instructing party who may be the applicant or related to the applicant. In the context of demand guarantees, commercial banks act as the guarantors stepping into the shoes of the instructing party undertaking to pay a beneficiary in case of presentation of a complying demand. The banks levy a fee for issuance of such an undertaking.

Letters of Credit and Trade Finance Income

A letter of credit is an irrevocable promise or undertaking made by a bank (referred to as an issuing bank) to pay a designated beneficiary, upon beneficiary's fulfillment of the undertaking's terms and conditions evidenced by provision of documents. It is a commitment made by a bank to pay a designated beneficiary if all requirements are met, the required documents are delivered, and the letter of credit's terms and conditions are fulfilled. The exporter has the option to ask a local bank in their jurisdiction to add confirmation to the LC in order to reduce the risk of the issuing bank's risk of non-payment under the LC if they are unsure about the credit worthiness of the issuing bank (Collyer, 2015).

By postponing payment obligations to the seller until performance has completed, the buyer's bank, which is the issuing bank, examines the necessary documents to prove that the seller has fulfilled his obligation as specified in the Letter of Credit, a Letter of Credit also protects the buyer. A Letter of Credit is a bank's promise to pay the LC beneficiary, also known as the exporter, upon receipt of the required supporting documents. It is made available upon the request of the importer or purchaser, often known as the applicant (Baboshkina, 2016).A Letter of Credit (LC) creates a framework wherein a bank agrees to pay an exporter on behalf of an importer when the exporter completes the LC's requirements by submitting the required papers, thereby reducing payment risk (Ermakov, Burmistrova , Bodin , Chursin , & Shevereva, 2018).Being an undertaking issued by the bank, the bank levies a fee upon issuance or confirmation of an LC.

Documentary Collections and Trade Finance Income

According to the International Chamber of Commerce (1995), "Collection" is the handling of documents by a bank in accordance with instructions received in order to obtain payment or acceptance; deliver documents against payment or acceptance; or deliver documents subject to other conditions that are specified. Additionally, it defines documentary collection as the handling of commercial papers alone or those that are handled in conjunction with financial documents. In a documentary collection, the exporter entrusts the obtaining of a payment to the remitting or exporter's bank which delivers corresponding documents to the collecting or importer's bank along with instructions of payment. Under this method of payment, the exporter must be prepared to take the risk that the importer will not accept the documents and accordingly will not pay the documents value (Dorsey, 2019).

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Documentary collections, like an LC, are concerned with the transfer of title documents rather than the direct transfer of goods. Unlike an LC, however, banks involved in the transaction do not guarantee payment and instead operate as document managers and payment collectors. As a result, document gathering methods pose a risk to both the exporter and the importer (Susmus & Baslangic, 2015). For the exporter, risk occurs because payment is not made prior to the goods shipment; also, the exporter assumes risk while the goods are in transit or in storage until payment or acceptance takes place. Other risk to exporter is the involved banks do not guarantee payments. For the importer, risk occurs if the goods shipped by the seller do not meet the agreed specifications. Therefore, from the exporter's perspective, Documentary Collections fall somewhere in between an LC and 'Open Account' in its desirability. Open account in trade finance is where seller extends credit terms to his buyer. Documentary Collections term of payment is preferred and utilized when the buyer and seller have a long-established and ongoing business relationship, and when the transaction does not require the additional protection and expense of an LC (Hinkelman, 2016). Being an undertaking, the bank levies a fee when handling documents.

DISCUSSION OF RESULTS AND FINDINGS

This section presents the results of the study based on several statements that examined selected Non-Funded Bank products that the banks offer to clients in the normal course of trade financing. In addition, the section also presents results on how these selected Non-Funded bank products that are offered to facilitate are booked in the banks' books of accounts. The study used a 5 point Likert scale where, 1= strongly disagree (SD), 2=disagree (D), 3=moderate (M), 4=agree (A), and 5=strongly agree (SA). This section also presents the mean and standard deviation of these statements based on this scale.

4.1 Frequency Distribution of Selected Non-Funded Bank products

The findings obtained in the study reveal that 85% of respondents strongly agreed that Trade Finance Non-Funded bank products include letters of credit and guarantees, 81% of the respondents strongly agreed that Trade Finance facilitates both international and local trade, and 81% of the respondents strongly agreed that the bank books a contingent liability upon issuance of guarantees. These findings show that majority of the respondents strongly agreed with the statements that were provided. This also means that, majority of commercial banks have different ways of recognizing income earned when offering these Non-Funded Trade Finance products.

Table 2.0: Frequency Distribution of selected Non-Funded Bank products

Selected Non-Funded Bank products						
	SD	**D**	**M**	**A**	**SA**	**Total**
Trade finance facilitates both international and local trade	4%	%	%	15%	81%	100%
Trade finance facilities are both funded and non-funded	%	%	%	26%	74%	100%
Trade finance non-funded facilities include Letters of Credit and Guarantees	4%	%	%	11%	85%	100%
The bank offers documentary collections handling services to clients to facilitate international trade as a non-funded product offering	4%	%	%	22%	74%	100%
The bank books a contingent liability upon issuance of Guarantee	4%	%	%	15%	81%	100%
The bank books a contingent liability upon issuance of Letters of Credit	4%	4%	4%	11%	77%	100%

ISSN No. 2454-6186 | DOI: 10.47772/IJRISS |Volume VII Issue XII December 2023

The bank doesn't book a contingent liability upon facilitation of documentary collection	11%	4%	7%	26%	52%	100%
Where the bank avails a documentary collection, it books a contingent liability	4%	4%	%	26%	66%	100%

4.4.2 Descriptive Statistics of Selected Non-Funded Bank products

The study also sought to analyse the views of the respondents on selected Non-Funded bank products using a table of means (M) and standard deviation (SD). The results on table 3.0 reveal that the respondents agreed on all the statements that were provided. For example: trade finance facilities are both funded and non-funded *(M= 4.74, SD= 0.447)*; trade finance non-funded facilities include letters of credit and guarantees *(M= 4.74, SD= 0.813)*; trade finance facilitates both international and local trade *(M= 4.70, SD= 0.823)*; and, the bank books a contingent liability upon issuance of guarantee *(M= 4.70, SD= 0.823)*.

Table 3.0: Descriptive Statistics of Selected Non-Funded Bank products

	N	Mean	Std. Deviation
Trade finance facilitates both international and local trade	27	4.7	0.823
Trade finance facilities are both funded and non-funded	27	4.74	0.447
Trade finance non-funded facilities include Letters of Credit and Guarantees	27	4.74	0.813
The bank offers documentary collections handling services to clients to facilitate international trade as a non-funded product offering	27	4.63	0.839
The bank books a contingent liability upon issuance of Guarantee	27	4.7	0.823
The bank books a contingent liability upon issuance of Letters of Credit	27	4.56	1.013
The bank doesn't book a contingent liability upon facilitation of documentary collection	27	4.04	1.344
Where the bank avails a documentary collection, it books a contingent liability	27	4.48	0.975

The second objective was to establish the effect of selected non-funded bank products on trade finance income among commercial banks in Kenya. The study found that majority of the respondents, at 85%, strongly agreed that trade finance non-funded products include letters of credit and guarantees *(M= 4.74, SD= 0.813)*, 81% of the respondents strongly agreed that trade finance facilitates both international and local trade *(M= 4.70, SD= 0.823)*, and 81% of the respondents strongly agreed that the bank books a contingent liability upon issuance of guarantee *(M= 4.70, SD= 0.823)*. The correlation analysis results revealed that issuance and handling of these selected Non-Funded bank products had a very strong positive linear statistical significance at r 0.865: $p \leq 0.01$. Additionally, the regression analysis results indicated that the coefficients for issuance or handling of Letters of Credit, Guarantees and Documentary collections was 0.563. This meant that, a unit increase in these selected non-funded bank

The study established that 85% of respondents strongly agreed that non-Funded bank products namely Letters of Credit and Guarantees are classified as Trade Finance products. 77% of the respondents strongly agreed that the bank books a contingent liability upon issuance of letters of credit. Collyer (2015) agrees that a Letter of Credit can be used where reliable credit information about the foreign bank is not available, but the exporter is satisfied with the information provided about its creditworthiness. Additionally, where the exporter is not sure about the credit worthiness of the issuing bank, the local bank can add confirmation to

the Letter of Credit to de-risk from the issuing bank's risk. Baboshkina (2016) confirms that buyers are also protected when a letter of credit is issued because they are not required to make any payments until the goods have been delivered and the buyers' bank has the documents confirming the delivery.

The findings of the study indicated that 81% of respondents strongly agreed and 15% of respondents agreed that Trade Finance facilitates both international and local trade. Furthermore, the results of the study found that 74% of respondents strongly agreed and 26% of respondents agreed that Trade Finance facilities are both funded and non-funded. These results are in line with Claessens, Hassib and Horen (2014) who confirm that banks provide financing and guarantees to exporters and importers during trade. Availability of external financing is important for domestic production as well as for exporting firms. Previous research confirms that countries that have strong financial institutions tend to export more, especially in financially vulnerable sectors.

The findings revealed that 74% of respondents strongly agreed and 22% of respondents agreed that the bank offers Documentary Collections handling services to clients to facilitate international trade as a Non-Funded product offering. These findings were in line with Hinkelman (2016) who argues that Documentary Collections term of payment is preferred and commonly used when the buyer and seller have worked together before and when the transaction does not require issuance of a Letter of Credit. However, this is in contrast with Antras and Foley (2014) who argue that, their research on international trade finance practices revealed that cash in advance and open accounts are more preferred and commonly used than letters of credit and documentary collections. Further research carried out on international trade finance practices of selected banks in Ethiopia revealed that majority of the banks do not automatically affect funds to the remitting bank after providing the shipping documents sent on Documentary Collection (Said, 2015).

According to the study, 66% of respondents strongly agreed that where the bank avails a documentary collection, it books a contingent liability. The results of the study also revealed that 52% of respondents strongly agreed that the bank doesn't book a contingent liability upon facilitation of Documentary Collection. Dorsey (2019) notes that, when exporters use Documentary Collection, they must be prepared to take the risk that the importer might not accept the documents and consequently, will not pay for the documents value. Susmus and Baslangic (2015) also confirm that, Documentary Collection process causes some risk to exporters and importers because unlike where a Letter of Credit is used, the banks involved in the transaction do not guarantee payment of goods but only act as handlers and collectors of payment.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The goal of the study was to establish the effect of selected non-funded products on trade finance income among commercial banks in Kenya. Specifically, study sought to establish whether the facilitation, handling or issuance of the chosen non-funded bank products namely Letters of Credit, Guarantees, and Documentary Collections, affected the trade finance income. The study found a substantial association between these products and Trade Finance income using inferential analysis, which included correlation analysis and regression analysis. The findings of the study revealed that a unit increase in facilitation, handling or issuance of these chosen non-funded bank products results in a 0.563 increase in trade finance income, implying a favorable influence on the trade finance income. The study comes to the conclusion that trade finance revenue is influenced by the facilitation, handling or issuance, and management of LCs, Guarantees, or Documentary collection.

Recommendations

The results of the study show that a component of trade finance revenue is affected by the issuance,

handling or management of trade finance instruments. The majority of commercial banks' non-funded bank products, which include letters of credit, guarantees, and documentary collections, are classified as trade finance solutions in the study's descriptive analysis. The study advises commercial banks to concentrate on sellingand revitalizing these product offerings in light of these findings. Commercial banks in Kenya are urged to expand their current trade finance offerings to electronic trade finance products such as electronic letters of creditand electronic guarantees in order to keep up with international banks innovations. Block Chain technology is another area that international banks have embraced to expedite the review and flow of documents in a trade finance context, but still remains a new frontier for the Kenyan banking sector. By establishing guidelines and a setting that would motivate Kenyan banks to adopt this technology, the Central Bank of Kenya can pave the way for this cutting-edge technology establishment and adoption in Kenya.

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