Shift from Letters of Credit to Open Account using Electronic Supply Chain Management Tools

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Agenda

• Market Perspective
• SWIFT TSU Perspective
• Corporate / Financial Institution perspectives
  – Corporate Challenges
  – Shift of Risks
  – Bank options
Market Perspective
Global Trade

$14 Trillion
Growth in international trade

US$ billions

CAGR
E.Europe 25%
Asia 15%
US 5%
EU 3%

Sources: World Trade Organisation
Top 10 US Trading Partners
= 65% of Total U.S. Foreign Trade

Source: U.S. Commercial Service – export.gov
Shift to Open Account

- The global trade business is in full transformation mode.
- Corporate mandate
  - Reduce costs
  - Leverage technology
- Banks have to choose how to satisfy existing, emerging, and evolving corporate client needs.
Migration to open account as seen at SWIFT

- Trade SWIFT Volumes
- Payment SWIFT Volumes

* Aug YTD Annualized

Source: SWIFT Traffic Watch
Pre-Financial Crisis

- World Trade USD 14 trillion*:  
  - 20% involves secured documentation  
  - 80% open account  
- Trend of the last 10-15 years importers and exporters moving to open account  
- Migration to open account limits bank involvement in trade to settlement  

*Source: Global Business Intelligence (GBI)
Current Environment

- First time since 1982, we seen a contraction in world trade – expected 6% for 2009*
- Suppliers finding pre- and post-shipment financing hard to obtain
- Even large buyers have a riskier profile as trading partners
- Less confidence in buyers, buyer’s country and its import regulations
- Unstable markets are a threat
- Contraction in trade – risk issue or liquidity issue?

*Source: International Chamber of Commerce

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As a result

- Shift back to bank intermediated trade finance and cash in advance
- “Renaissance of the Letter of Credit” – maybe?
- Increase in demand of documentary collections
- However, banks facing liquidity squeeze and more stringent review of creditworthiness
Going forward...

- Current global recession slows the movement to open account
- Open account transactions will continue
- Companies will focus on their supply chains to maximize working capital
- Treasurer’s perspective:
  - Increasing emphasis on integrating trade finance solutions with cash, payments, & forecasting for optimal working capital management
- Less paper, more information
  - Visibility and control of cash now translates also to visibility and control of trade flows
SWIFT TSU Perspective
What is SWIFT?

A co-operative organization serving the financial industry

A provider of highly secure financial messaging services

The financial standardisation body

- 3.5 billion messages/year
- 8,740 customers
- 209 countries
- Latest Peak day: 17.8 million messages
Financial Supply Chain Management

PROCESSING EFFICIENCY

Risk
- PO authentication
- FX hedging
- Compliance

Services
- Cash forecasting
- Discrepancy handling
- Dispute management

Back-office
- Document preparation
- A/P & A/R reconciliation

Order → Make → Ship → Invoice → Rec → Pay → Sell → Collect

Inventory finance

Pre-shipment finance  Post-shipment finance  Receivables finance

LIQUIDITY MANAGEMENT

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SWIFT’s Trade Services Utility (TSU)

TSU
Standards
Messaging
Matching & workflow
Rulebook

BANK SERVICES
Risk mitigation
Financing
In-sourcing
Services

Collaboration

Competition

SWIFT messages
Trade documentation

Corporate
Trade facilitators
TSU key features

- Supports the exchange of standardized information between banks – bank to bank only
- Matches data elements extracted from trade documents (Purchase Order, Invoice, Transport & Certificates)
- Enables banks to:
  - enhance existing services
  - develop new services

**Diagram:**

- Invoice data
- Purchase Order data
- Transport data
- Certificate data
TSU benefits to banks & industry

**Bank**
- Enhance existing or build new products for corporates
- Build products *in stages*, according to needs of their customers
- Enables trigger points by monitoring of transactions
- Lowers cost of investment in a shared infrastructure
- Increases automation of data checking
- Reduces risks with dual party transaction authentication
- Matching baseline purchase orders results in fewer discrepancies
- Creates reusable computer readable data elements

**Industry**
- Helps the industry move toward a standard approach to business
- Common (XML) standards facilitate STP and handling efficiencies
- Provides interoperability between banks
- Separates collaborative space and competitive space
- Bank neutral service provider; trusted delivery and resilience
- Respects existing corporate business practices

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Standardizing Financial Supply Chain Management Globally

Multi-lateral TSU Rulebook for banks (completed)

Changes to TSU agreement:
1. Dispute resolution
2. Additional SLAs
3. Payment rules
4. Etc.

Corp-to-Bank Agreements:
1. Pre-shipment Finance
2. Post-shipment Finance
3. O/A Export Receivables
4. Import Finance
5. Purchase to Pay
6. Payables Finance
7. Etc.

Master Risk Participation
Facilitate secondary markets

Proposal on accountancy treatment

Buyer

Seller

TSU

Association for Financial Professionals

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TSU - Filling the void for Open Account

Rules & Market Practices

Shared Infrastructure

Message Standards

Letters of Credit

Open Account

- UCP
- SWIFTNet
- Category 4&7

- TSU Rulebook
- Standardized Agreements

ISO 20022

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TSU - Growing Community of Banks

88 Trade Banks
104 Locations
30 Countries / Territories
SWIFT – greater coverage across the risk spectrum

- Payments *
  - PO ** Finance
  - Conditional Payment **
  - Structured Finance ***

- Collections *

- Letters of Credit *

Corporate Payment Obligation

(-) Bank engagement in corporate trade (+)

Open account trading

Bank facilitated trading

* Available  ** Introduced  ** Not addressed

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The corporate / bank perspective
Challenges of globalization

- Complexity of managing a business across multiple borders:
  - Cross-border payments and collections
  - Local payables, receivables, currency exposure associated with daily operating expenses and payroll
  - Tax strategies and payments
  - Access to working capital and managing different interest rates
  - Cross border funding and repatriating money
  - Improved cash forecasting
  - Linking physical, information and financial supply chain and increasing visibility in supply chain events
  - Risk Management
3 Supply Chains underlying B2B eCommerce

Physical Supply Chain
- Planning
- Purchasing
- Production
- Distribution
- Payment

Information Supply Chain
- Catalog
- Purchase Order
- Logistics Tracking
- Invoice
- Remittance

Financial Supply Chain
- Working Capital Management
- Risk Management
- Receivables/Payables Financing
- Payment Initiation
- Settlement

Source: Financial Insights 2008
Counter parties are driven by different needs

**Importer (Buyer)**
- P.O. Issuance
- Accounts Receivable
- Increase Days Payable Outstanding (DPO)
- Looking for credit terms
- Buy in own currency
- Trade Payables Financing
- Reducing costs including banking fees

**Exporter (Supplier)**
- Invoicing
- Accounts Payable
- Reduce Days Sales Outstanding (DSO)
- Minimize credit risks
- Sell in own currency
- Pre- and post-export financing
- Reducing costs including banking fees

**Procure to Pay Cycle**

**Order to Cash Cycle**
Heightened Sensitivity to Risk Management

- More companies are managing cash more prudently due to downturn
  - Heightened sensitivity to the risks associated with the solvency of their customers and suppliers
  - More are actively collecting receivables, and imposing stricter credit policies
  - Country risk and settlement practices
  - Constricted liquidity
    - Reduction in access to external funding
    - Lower sales demand
Buyer Risk Assessment

Low Risk Buyer
- Open Account Terms
- Documentary Collections (Acceptance)

Medium Risk Buyer
- Open Account Terms with Standby L/C or Export Credit Insurance
- Documentary Collections

High Risk Buyer
- Cash in Advance
- Confirmed Letter of Credit
- Letter of Credit

Increasing Risk
Shift of Risk from Bank to Corporate in Open Account

- Banks no longer provide the financial guarantee or third-party review of documents
- Lower costs, but the buyer assumes additional risks and administrative burdens:
  - Trade Document (P.O.s, invoices, bills of lading…) checking to ensure compliance with trade terms
  - Compliance shift (AML)
  - May require staff to handle functions that were previously handled by the bank

Best Practice: Buyers and Sellers need to ensure they understand what the additional costs and risks are to their transactions and what (if anything) a bank may or may not support under open account terms.
Shift of Risk—a closer look

- The change in settlement method from the traditional Letter of Credit and Documentary Collections where either documents are...
  - fully examined:
    - LC terms - banks examine for both Documentary Compliance to the credit under the provisions / guidelines of UCP600 and ISBP - International Standard Banking Practices and ISP 98 - International Standby LC Practices and banks also review for Regulatory Compliance - OFAC, BSA/AML
  - or partially examined:
    - Documentary Collection terms - where a bank performs a quantitative examination of documents to the Collection Cover Letter and performs a level of Regulatory Compliance check

Best practice: Understanding the Credit/Payment and Risk Reporting decisions that were previously undertaken by the bank.
Bank Services Used to Assist with Open Account Transactions

**Information Supply Chain**
- Trade document compliance checking
- Bank reference checking
- Outsourcing payables management
- Trade counterparty information
- Logistics support
- Documentation preparation
- Payment systems
- Trade Outsourcing accounts receivable management
- Purchase order transaction information & management report status

**Financial Supply Chain**
- Import/purchaser financing against confirmed purchase orders
- Financing vendor receivables
- Import/purchaser financing against approved invoices
- Credit insurance
- FX hedging
- Pre-export finance against purchase orders
- Post-export finance against approved invoices
- Post-export finance against guaranteed invoices
- Ability to finance inventory in transit
- Supplier Finance Program
- Factoring
- Payment guarantees

Source: Flmetrix and PNC Data and Client Analysis
Value Adds to Supply Chain from your Bank

• SWIFT TSU
  – Banks at various stages of assessing the applicability and integration capability of the TSU with TM product offerings (payments and information management) as well as lending area

• Purchase Order and Invoice Processing Management
  – Issuance, Matching and Settlement

• Mostly post-acceptance financing today based on approved invoice
  – Example: Trade Payables Finance (i.e. discounting trade payables to vendors allowing the trading partners to maximize the management of working capital

• Earlier stages of financing emerging
  – Risks, complexities, and benefits of pre-export, in-transit inventory, and event-triggered financing models
Conclusions

- Cross border trade is alive and well!
- The Letter of Credit is here to stay, though open account will continue to gain momentum
- Increasing reliance on automation
- Innovation in information flows
  - Enhances working capital management
- Innovation in solution structuring
  - Solutions reaching into pre-shipment
- Convergence of cash, payables, forecasting and trade finance
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Exhibits
More Information

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