

An issue with trust

Although it is unlikely that the use of letters of credit will die out, the trend towards open account trade continues. **GTR** and Misys's roundtable held at Sibos highlighted some of the key challenges ahead.

“**P**eople want to move back to open account,” asserted Ashutosh Kumar, global head of local corporate products at Standard Chartered, at the **GTR**-Misys roundtable hosted at Sibos in late October. At the height of the financial crisis, as global trade plummeted, the use of letters of credit (LC) saw a slight renaissance as banks and corporates wanted to cover their non-payment risks. But as recovery sets in, and trust returns, the market is swinging back to the more long-term trend of corporates preferring to trade on an open account basis. Sumit Jamuar, managing director and head of sales, financial institutions, Lloyds TSB commented: “Every crisis causes more lack of trust. That is why LCs are still here, as they deal with the issue of trust.” But, Kumar noted that the LC instrument is relatively inefficient. “The example I keep quoting is if you want to move a million dollars of oil from Singapore to Indonesia it takes one day by ship, but if you present documents for the same shipment under an LC it will take a week. “The physical supply chain is still way ahead of the financial supply chain.” With that in mind, Kumar added that despite the heightened risk environment seen over the

past two years, “open account is here to stay”, and banks will need to find a way to maintain an important role in the international trading activities of their corporate clients.

But, participants at the roundtable also noted that open account trade is not without its own faults and inefficiencies.

For instance, open account trade is relatively reliant on there being a strong credit insurance market to cover their non-payment risks, a risk automatically covered by an LC.

“Globally you have maybe five or so large insurers covering most of the industry, whereas you have over 2,000 banks covering the LC business. There really is no comparison, and this will remain a challenge for the open account market,” explained Kumar.

Furthermore, there is a slight question mark over the reliability of the credit insurance market given that many exporters and importers had their cover cut at the height of the crisis.

An additional challenge for open account business is the lack of a standard or “harmonised framework”, as Kumar noted, under which to conduct open account business.

With these obstacles in mind, LCs will not be consigned to history. As Eric Henry, head of

e-Trade, global trade solutions, at BNP Paribas noted; the two products don't need to compete, but can be complementary bank offerings.

"One thing we see is that in Asia we continue to issue substantial volumes of LCs. For instance in Bangladesh, we cannot deal with this country on an open account basis, so LCs will remain an important instrument, until perhaps we get new instruments."

Patrik Zekkar at SEB also noted that during the crisis, and even now, LCs have been seen as a way of not just mitigating counterparty risk, but also a means of better managing working capital.

"From a cash conversion cycle point of view at treasury level, it is more costly to have a 60, 90, or 120 day invoice, when if you have a signed LC, you can get payment in five or seven days.

"There are trading houses that used LCs, not because they are afraid of the counterparty risk, but due to the cost of cash, the cost of an LC was less than the cost of the alternatives they had available to them".

Zekkar also defended LCs against some of the accusations of being inefficient. "We have the capacity to turn around an LC in three hours – and that is a huge step."

The group also discussed the establishment of Swift's Bank Payment Obligation (BPO), a relatively new Trade Services Utility (TSU) programme designed to eliminate some of the discussed issues related to LCs.

The BPO is an irrevocable obligation for an importer bank to pay, which is conditional on the presentation of electronic data from an exporter bank, via the TSU interface.

The hope is that banks will only be presented with relevant information, rather than unnecessary secondary data, ultimately reducing the risk of human error and fraud.

But even this innovation has its challenges, with the group discussing the challenge of enforceability in the event a BPO issuing bank doesn't pay.

Kumar remarked: "There is still work happening there. With LC transactions, you have UCP regulations, even in the smallest regions they know about UCP. We need ICC to help develop similar rules for BPO transactions."

The group recognised that the industry had made huge steps towards speeding up and automating the processing time for LCs, but that despite all efforts, customers will ultimately be looking for faster less paper-intensive services that the structure of the LC instrument just does not allow for.

"The question is not whether LCs will die, but whether they keep in line with global trade? Trade

will grow at 13% but will there be additional LC issuance? Will they keep in pace with global trade? Definitely not. From an efficiency perspective – they are just not there," observed Kumar.

"Talk to the customers. When banks send documents under an LC from one bank to the next, that can result in four days of working capital lost for the customer."

Olivier Berthier, solutions director, transaction

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Ashutosh Kumar, Standard Chartered

banking at Misys, observed similar trends. "As a solutions provider I can say there is still room to significantly improve the operational efficiency around traditional trade.

"Making things faster, ensuring a quicker turnaround, but I also hear you that at some point with the LC process, however well-developed it becomes, it will never wholly be aligned with the new world of physical supply chain." **GTR**

PARTICIPANTS

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