

Recent trends in trade payment services

There are places at the trade table
for both letters of credit and open account

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Historically, trade finance has been provided predominantly through letters of credit: a letter of credit is issued by a bank on behalf of an importer that promises payment for goods or services, provided the exporter presents documents that comply fully with the terms of the issued credit. For an importer, a bank's letter of credit enhances their credit worthiness to exporters who might otherwise know little of them and it also reduces risk by assuring that payment will be made only after the necessary documents have been complied with. For exporters, the international enforcement of the letter of credit process reduces commercial credit risk and assures payment upon documentary compliance.

Technological advances aside, the letter of credit is largely the same instrument it was when first issued more than eight hundred year ago. They have remained viable through the international agreements among the world's nations that address standards for how letters of credit operate.

NEW ERA OF GLOBAL TRADE

For all of their resilience and venerability, letters of credit – as trade instruments – have been giving way to open account transactions.

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Open account consists of the exporter extending a line of credit directly to the importer with payment made upon mutually agreed terms. One reason for this change is that as global trade has increased, the world has become, figuratively, a smaller place, with importers and exporters less often the strangers to each other that they once were. Also, open account allows each side to operate without the cost (i.e., the banks' fees) of the letter of credit process.

Open account also benefits from advances in technology that have increased the speed, visibility and transparency along the supply chain: it is much easier than it used to be to keep track of goods throughout the shipping process. Technology allows similar speed and visibility

within the financial supply chain as well, enabling the movement of funds to stay more in sync with the movement of goods.

Compared to these advantages, letters of credit – fairly or not – have come to be seen as a cumbersome, slow and expensive way of doing business that changing times have rendered antique. Whether the advantages in open account are as clear-cut as stated is disputable; however, what is not disputable is that open account changes the balance of risk between importer and exporter.

PAYMENT RISK CONTINUUM

If one were to construct a risk continuum – with high risk at one end and low risk at the other – it becomes readily clear that, for an importer and exporter, risk flows in opposite directions. For an exporter, the best arrangement is cash in advance, payment guaranteed before goods are shipped. This is, conversely, the riskiest arrangement for an importer, who has no real guarantee that it will ever see delivery on what it's purchased, or that the good will arrive in a timely fashion. Yet, if demand for an exporter's product is great enough, they may be able to secure payment-in-advance financing, although this is not often the case.

What is notable about the shift away from letters of credit to open account, is that it provides the lowest risk for the importer, but is the

least secure for the exporter, who has no guarantee of payment or who might see payment delayed to the detriment of their liquidity and cash flow. Even given the increased familiarity between exporters and importers in a shrinking global marketplace, this shift in the balance of risk has been dramatic. What are the factors that have forced exporters to so overwhelmingly accept the risk that open account entails? And do banks have a role to play in balancing that risk for exporters?

CHANGING TRADE MARKETPLACE

One answer is that the marketplace has changed in ways other than

PROS AND CONS

LETTERS OF CREDIT

Slow

Safe

Expensive

OPEN ACCOUNT

Fast

Risky

Cheap



simply becoming “smaller.” In the last 20 years, the Organization for Economic Cooperation and Development (OECD) nations – so-called developed countries – have shifted from being primarily producers and exporters to buyers and importers, largely from the non-OECD, or “developing” nations. In many cases, multinational corporations from the OECD countries have established offices in the developing nations, so familiarity between buyer and seller is indeed part of the reason.

But there is also a shift in power and leverage – the non-OECD producers have less bargaining power and must accept the terms offered or lose the business. This can cause – and has caused – problems for exporters who, without the security of a letter of credit, find it more difficult to secure funding from their lending banks to maintain production while awaiting payment for work already completed. Further, the OECD buyers may also insist on deferred payment terms and “just-in-time” delivery, exacerbating the situation for the exporter.

It needs to be noted that, despite a diminished use of letters of credit on a percentage basis, use has increased on a volume basis. Letter of credit use varies from region to region and that they are still popular between OECD and non-OECD nations in Africa, the Middle East and south and southeast Asia. Further, if letters of credit were in part a victim of changing times, the changed times we are in now – the global shrinkage in available credit sources – will likely revive them. Bank consolidation and failure and a practically non-existent secondary market have engendered a rise in the price of letters of credit and a slowed market move to open account.

ROLE FOR BANKS IN OPEN ACCOUNT

Since many of the inherent difficulties in letter of credit trade remain in open account transactions – including proper documentation, dispute reconciliation and actual management of the financial supply chain – banks’ expertise and long histories in trade processing place them in an ideal position to be active, even necessary, players in open account processing.

However, banks that want to keep pace are no less affected by the economic slow-down than the companies they hope to serve. To become value-adding players in open account, many banks need to develop new products (e.g., web-based initiation and tracking systems) and technology solutions that can more easily wed the systems of importers and exporters. This may require many banks to update their existing systems in the face of increasingly scarce capital, something they may be unable to afford. Banks may be forced to consider leaving the trade finance business altogether, something they are loath to do. For such banks, an outsourced trade service solution may be an answer.

Even as use of open account increases, and banks move to keep pace, few if any companies will completely abandon letters of credit. Banks need to be able to efficiently provide both services. An approach is needed that combines data and financing with systems capable of handling both open account and letter of credit flow. And, as banks become more active in open account, working with both sides to a trade agreement, they can lessen the risk that exporters face when working with importers directly and help maintain a workable level of risk between parties. ■