A blurry picture

Technology in the supply chain finance field is blurring the differences with traditional trade finance, *Justin Pugsley* writes.

Technology is steadily blurring the lines between 'pure' letters of credit (LCs) and open account transactions. As banking platforms become increasingly automated and flexible, users are more easily able to pick and mix the best features from the two payment methods.

Indeed, trends such as automation are not only supporting supply chain finance (SCF), but are also speeding up the processes surrounding the issuance and the management of letters of credit. The trend towards greater transparency and availability of data is also playing a role in merging the two processes.

Many trade finance banking portals, such as ABN AMRO's award-winning MaxTrad product, allow users to choose between issuing an LC or going for an open account transaction when paying suppliers.

The data for the two payment methods still originates from the same purchase order. Meanwhile, SCF uses the same finance infrastructure that has been built around LCs.

"We want automation to be seamless with other procurement activities," says Michael Quinn, senior vice-president, product executive for global trade with JPMorganChase. "We're really focused on bringing in the customer's information into their ERP or payable system."

Quinn at JPMC:
Still has faith in LCs

ERP or enterprise resource planning is an attempt to integrate all the data and processes of an organisation into a unified system. Practically all large organisations operate one or many ERP systems.

Meanwhile, the leading ERP vendors, Oracle and SAP, are steadily releasing more sophisticated modules designed to handle different aspects of international trade. Indeed, ERP and SCF are becoming increasingly closely integrated.

Quinn explains that based on a set of pre-agreed roles, the bank can create an LC for the client based on their purchase order or just go to open account.

"LCs should be an integrated part of a corporate's procurement strategy, but as customers increasingly move to open account, they don't need LCs in the volumes they used to," says Quinn.

Indeed, leading banking software developer, Misys, no longer differentiates between the technology for automating LCs and open account transactions. ABN AMRO, on the other hand, simply talks about devising trade finance solutions that best fit their clients' circumstances.

Increasing capacity

Meanwhile, Steve Starace, director, trade services banking and investments, with specialist trade finance software developer CGI says that although the concept of automation has been around for a while, new technologies are increasing capability.

Coupled with that, there has been a veritable drive in recent years by multinationals to improve transactional efficiency and reduce financing costs.

A fundamental change brought about by SCF is that the burden of financing international trade transactions has increasingly been shifted to suppliers. However, innovative SCF solutions enable

those suppliers to leverage their finance costs off the often higher credit ratings of their multinational customers.

"Technology, if focused in the right way, in the right areas, can be really transformational in terms of cost and driving efficiency," says Starace.

He adds that defining the optimal processing model is one of the key elements of that transformation. However, it is defining those models that many in the banking community have been struggling with.

In the meantime, various banking sources reckon LCs now account for just 12-20% of world trade and that share is shrinking by the year. In fact, it could be argued that LCs are steadily becoming a sub-segment of SCF or even a market niche. Basically, they are relatively expensive to use and complex to administer.

"People use LCs for specific purposes, such as when they start a trading relationship with a new supplier," says Quinn.

Despite their falling share of world trade, Quinn along with other bankers believes that LCs will still have a role in the future. Not least, they are designed to provide both buyer and seller with a degree of safety when doing business in the early days of their trading relationship.

At times of global instability, LCs could well come back into fashion as trading partners suddenly become much more focused on risk.

Indeed, LCs are a type of risk mitigation tool and like all such tools they come at a cost.

And for that purpose, the LC is probably still the best instrument available for fulfilling that role. After five centuries of use, it is likely to remain so for the foreseeable future.

However, once a relationship is cemented, trading partners can and increasingly do move towards transacting on an open account basis. This reduces costs, speeds up transactions and reduces the administrative burden associated with international trade.

> "This reduces costs, speeds up transactions and reduces the administrative burden associated with international trade"

Light LCs

But even then aspects of LCs can still be useful. It can be a case of banks providing similar levels of security in an open account transaction that they would provide under a traditional LC.

"So for example it could be confirming a purchase order and confirming that the payment will be made against a proper invoice and other relevant documentation," says Oliver Berthier, Trade Portal product and business development manager with

Berthier at Misys:
Banks should respect clients

Misys Banking Systems in Paris. In other words, a sort of 'light' LC.

"We have been able to combine for our clients different aspects of LCs with open account as long as invoices are accepted by the buyer and we have all the necessary data," confirms Adnan Ghani, global head of trade services, transaction banking, with ABN AMRO.

Building on that, Ghani says the bank can then provide supplier finance against those documents. Industry sources reckon such innovation is likely to grow as banks strive to offer their clients tailored, but competitively priced solutions.

Indeed, these are all benefits that derive from greater transparency of the supply chain. The more aware the bank is of various events in the supply chain, the more it is able to devise very specific payment and financing solutions for coporates.

For the more advanced banks there is also the opportunity to offer, in an automated fashion, a range of products such hedging solutions or insurance at the various stages of the transaction.

Fewer errors now

But there are other ways in which technology is supporting LCs. "Technology

is dramatically reducing not only the paperwork, but the error rates involved in manual processing and the checking and mailing time and the delays that involves," explains Ghani. "And then finally this impacts on providing the financing."

Ghani at ABN:
Tailored and competitive offerings

It is not uncommon for a large multinational with turnover in billions of dollars being able to save hundreds of millions of dollars a year in financing costs. If the time involved in processing LCs can be reduced by 20 days, this can translate into shorter funding requirements. Something that is not lost on chief financial officers and treasurers.
Quinn says if existing automation methods are used to the full, a corporate can generate savings of 20-25% on its LC-related transactions. And emphasising those benefits, Starace says automation can reduce error rates by 50%. This is largely because the same data doesn't need to be re-entered several times.
The fact that purchase orders and invoices can be made electronic relatively easily dramatically increases the potential for efficiency.
Cross-referencing data between the content of the invoice and the purchase order is much more effective when done electronically. Errors can be more quickly detected and corrected. And once the invoice is approved by the buyer – electronically – this can automatically trigger other events such as supplier financing.

"That's where we came up with our document preparation solution. The idea was to improve efficiency for the client," says Ghani. "We have automated document preparation and the checking process as much as possible and we also do some following up with third parties to ensure that their cash is collected as fast possible."
Where there is a trading hub or a community of trusted suppliers serving a large multinational, the opportunities for automation are substantial.
For example: "The supplier can obtain from the buyer much of the necessary information to populate his documents within our system," says Quinn. "Much of that data can then update the buyer's ERP system. We have a facility that allows end-to-end documents."
Service level agreements (SLA) help define the relationship between bank and corporate customer. Although bank/client relationships might be based on a particular level of service – subtle variations can creep in, as each corporate is essentially unique. Some may even require a completely tailored service.
Monitoring and properly implementing SLAs therefore poses challenges of its own. "SLAs are a key to LC automation. They are a way for banks to set different levels of service and it is very important for banks to respect those commitments to their clients," says Berthier.
To do this, banks need to know easily what their commitment is to each customer. Automating SLAs makes these tasks a lot easier and straightforward. It also allows the bank to monitor its own performance relative to the commitments in those SLAs.

Offshore processing

Yet another benefit of automation is being able to offshore much of the preparation and administration behind LCs. Many banks are doing this to reduce costs by locating much of that work in low-cost countries. This is being made possible thanks to the ability to transfer data electronically.
An example of this is CGI. It incorporates imaging into its trade services solutions. Again, this is not a new technology, but it is the way it is used that makes it so effective.
"We've integrated it in a new way with the right kind of workflow management tools

that can allow banks to work in a truly effective way," says Starace. This means that banks can more easily circulate documents between branches and processing centres.

Starace explains that some banks are using this solution to help support centralised processing centres in low cost countries.

"Documents can be presented locally and indexed locally and then routed to a centralised hub for processing," explains Starace.

Such solutions open up a variety of different operating models. For instance, different aspects of LCs can be processed in different centres. Or an over-burdened centre can route some work to a centre with spare capacity. Indeed, this might be crucial for a bank to meet its SLA with a customer.

However, ABN AMRO, which has a processing centre in Chennai, India, working 24/7, has taken the process further. "For us India is not just about cost reduction. It's about being able to offer a superior service to our customers," says Ghani.

He cites the example of a client approaching the bank after business hours urgently needing an LC to be issued.

"Most of the work can be done in our centre in Chennai and the LC will be ready next day," says Ghani.

Other banks will route the work to other regional offices around the world as the work "follows the sun".

Revolution or evolution?

LC automation could however go much further than it does today. After all, the technology is readily available.

The road block is that much of the crucial documentation can't be dematerialised. Electronic documents and signatures simply aren't legally binding in many jurisdictions. In many instances the capability doesn't exist either. For example, there is often an issue with chambers of commerce or embassies issuing certificates of origin. Often they don't possess the means to make them electronic.

Bolero made a valiant attempt to dematerialise a lot of that documentation. It created a centralised document repository. It also attempted to establish a legal framework to enable more documentation to be dematerialised.

Despite potentially significant cost savings and creating greater levels of efficiency and transparency, the initiative has never really gained wide industry acceptance yet.

Some industry sources think the idea may have been ahead of its time and the rest of the world simply wasn't ready for it. Others note problems with trying to achieve standardisation and a raft of legal issues.

In the end, the world trading community has opted to go for a more gradual and evolutionary approach. Indeed, had it taken off it would have dramatically transformed the trade services landscape. This was one revolution that apparently had too many stumbling blocks to seriously take hold, say industry sources.

Generally, successful technological solutions build on existing systems and frameworks and simply make them more efficient.

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This is one reason why web-based software-to-service solutions are gaining popularity. The user requires little or no change to their existing legacy systems to interact with a web-based solution.

Nonetheless, innovation is not stopping there. The next big event for the trade services sector is the roll-out of Swift's Trade Services Utility (TSU). It was devised with open account transactions in mind. It is essentially a matching and workflow engine. Banks use this to support the matching of trade-related transaction data. TSU can match purchase orders and invoice data along with transport documents.

TSU is an attempt to restore the visibility of the supply chain to banks, which they once enjoyed when most international transactions were done via LCs. Open account transactions, by contrast, offer little in the way of supply chain visibility to banks.

The greater level of transparency offered by TSU will enable banks to offer more innovative financing solutions and where necessary integrate aspects of LCs.

Interestingly, Bolero is a major technology supplier to the TSU.

No doubt many of the legal issues that stumbled Bolero will be resolved in the coming years as governments and supranational institutions make the trading framework more e-friendly. There are many efficiencies to be mined in that area, which would benefit international trade.

In the meantime, TSU will continue to drive efficiencies that are supportive of SCF. Also, Bolero is continuing in its efforts to dematerialise trade-related paperwork.

Casio Computer of Japan is using Bolero's platform to dematerialise some export LC documentation such as bills of lading. This covers goods being shipped direct from Hong Kong to a buyer in South Korea.

However, Casio intends to expand the initiative across its Asian operations. The initiative dramatically reduces the paper chase and speeds up the time for LCs to be issued. It also reduces the importer's trade-related costs.

LCs may well be accounting for an ever-smaller proportion of world trade transactions, nonetheless as a product they are becoming quicker and cheaper to issue thanks to technology.

This doesn't mean to say they'll be making a comeback anytime soon. If they do, it will be down to other factors such as an increasingly risky global political/economic environment.

In the meantime, open account transactions remain cheaper and more cost effective for corporates to transact with already trusted parties. There will always be a niche for LCs in international trade, particularly where there is a need to help manage risk.

However, technology is enabling banks to more easily pick apart components of LCs and combine them with open account transactions. This is useful to meet the particular needs of corporates looking for effective, yet competitive solutions to their trading challenges. As such, technology is increasingly blurring the boundaries between traditional trade finance and the newer area of supply chain finance.