

Report

Advancing critical dialogue

Guaranteeing payments for open account trade

How far will the Bank Payment Obligation (BPO) bring comfort to trading counterparties operating in an open account environment?

Traditional trade finance is driven by letters of credit (LC), which act as both a financing mechanism and bank payment guarantee underpinned by a globally recognised set of rules and supply chain documentation. With over 80 years of precedent and usage, the LC constitutes a bulletproof guarantee for everyone in the supply chain from buyers and suppliers to the banks themselves.

OPTING FOR OPEN ACCOUNT

The drawback of the LC is that it is slow, inflexible, administration-intensive and costly in terms of both paper and processing. “LC documents can go astray and even when they don’t it is not uncommon for goods to arrive with the customer before the paperwork,” says David Vermeylen, global credit manager at BP Chemicals Ltd., a business unit of BP. “Then the documents must be processed with purchase orders and a complex set of other forms matched,

approved and passed onto the bank for payment. The whole cycle can easily take up to a month or more. In addition, generating high volumes of paper is labour-intensive and prone to human error, making it not only expensive but open to risk.”

To speed and simplify the process, supply chain partners are trending towards electronic trade finance with open account (OA) terms whereby goods are shipped and delivered before payment is due. While this option is favoured by importers for reasons of cost and cash flow, it poses a higher risk for exporters. Offsetting this risk is the fact that OA requires minimal documentation (typically just the purchase order, invoice and proof of shipping) and boosts competitiveness within the global market. Indeed, whether it is in their interests or not, suppliers are increasingly being forced to offer OA to win new business.

MANAGING THE RISK

Given that OA has none of the traditional LC guarantees, how are exporters managing the risks of payment default? These can be mitigated through buying credit insurance,



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Olivier Berthier, global solutions director, transaction banking, Misys



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Marcus Hughes, director, Bottomline Technologies

arranging standby LCs or factoring (selling on the invoice portfolio at a discount), but at core it comes down to ‘know thy customer’. “In the case of traditional payment guarantees where banks cover the risk, they have built up an extensive knowledge of all their counterparties,” says Olivier Berthier, global solutions director, transaction banking, at Misys. “However, with open account, it is up to the exporters to know their customers’ risk profile. For this reason OA is mostly used for long-standing and trusted relationships while LCs are reserved for new customers, often in emerging markets.”

Jose Carlos Guedes, master financial analyst at Brazilian mining firm, Vale S.A., confirms this. “It is up to our risk management department to decide which customers will have OA or LC terms

Adnan Ghani, head of trade, global transaction services, RBS



based on our relationship history, their credit record and financial situation,” he comments. “Today most of our trade with China is based on LCs, but it takes a long time to get paid. From the bill of lading date to the issuing bank in China releasing funds takes an average of 25-30 days for sales on an ‘at sight’ basis. What we’d like from our banks is a product that helps us get our money faster.”

BPO: A RATIONAL MIGRATION

To mitigate OA risks and to speed the payment cycle, SWIFT, together with the International Chamber of Commerce (ICC) Banking Commission and a working group of banks and corporates, undertook an initiative to establish a Bank Payment Obligation (BPO). BPO gives banks the tools to provide their trade finance customers with guarantees and other multi-banking services on OA terms. Based on the ISO 20022 messaging platform, it brings together TSU, SWIFT’s trade services matching utility, with a set of business rules that replace the complexity of LC paper forms with dynamic data that can be automatically streamed into supply chain applications.

“We see BPO to be a rational migration for electronic trade finance, but the end-to-end supply chain is endlessly complicated so the challenges cannot be underestimated,” says Marcus Hughes, director at Bottomline Technologies, which provides a global purchase-to-pay platform for 600 buyers and 140,000 suppliers. “The key to BPO success lies in the standardisation of documents and message types.”

A year in the drafting, the BPO rulebook is now pending submission to the Commission for certification. Says ICC’s Thierry Senechal, senior policy manager: “For the last 80 years banks have been used to having a paper trail so BPO represents disruptive change. Achieving the critical mass adoption needed to create a global standard is a collaborative process and should involve both banks and corporates, with visible benefits for all. Strictly speaking there’s no time limit, but we expect a consensus on BPO rules could be reached within the next two years.”

SUPPLIERS EMBRACE BPO

BPO adoption presents something of a chicken and egg conundrum, according to Berthier. “Creating a set of rules in the first place relies upon demonstrable evidence gathered from real live transactions and this takes time to amass.” Towards building this evidence, BPO is currently being tested by some of the corporates in the working group. “BPO gives us the best of both worlds: electronic trade finance with a payment guarantee,” says BP Chemical’s Vermeylen. Vale’s Guedes is equally enthusiastic. “Our bank puts information into the BPO platform and it is electronically matched with data held by our customer’s bank,” he says. “At that point payment should be immediate. BPO has reduced payment times from 30 days down to an average of 10 days. Given that we export over USD 1.5 billion a month to China alone, even one day’s reduction in DSO (Day Sales Outstanding) can release a lot of working capital.”



ONBOARDING BANKS

One of OA's potential side effects is bank disintermediation. "If a customer has moved to OA their bank may not even realise it unless they notice a drop in the number of LCs being issued," notes Mike Quinn, managing director, global trade, at J.P. Morgan. BPO offers a way back in. Far from losing LC fees as some may fear, the additional volume of electronic BPO trade activity means more transaction fees with lower processing costs.

There are other benefits to being in the loop, Berthier points out. "Massive supply chain data flows not only provide the visibility needed for risk mitigation, they increase cross-selling opportunities," he says. "For example by capturing data from a purchase order, the bank can be alerted to a customer's need for foreign currency."

Despite BPO's benefits, banks are cautious. Adnan Ghani, head of trade, global transaction services, RBS, points out that, "BPO needs ICC endorsement as a precondition for adoption. The main challenge, however, is a lack of awareness. Education about BPO is needed within the bank in areas like credit, trade finance and cash management."

Hughes agrees. "Cash management tends to regard invoices as an extension of the payment process while trade finance sees invoices and purchase orders as evidence of underlying supply chain transactions," he says. "The two need to converge." Adds Quinn: "There are multiple touchpoints in a bank that need to feel comfortable. For example, the banker with credit responsibility for an importer issues an LC and knows how it works. He needs to be equally aware of BPO and its benefits and be able to communicate these to his customer."

Berthier identifies Basel III as another obstacle to adoption, causing confusion



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about how to calculate risk and how much capital to set aside for BPO transactions. He also believes trade finance practitioners traditionally tend to resist change. "To overcome this we are seeing banks starting to hire people with commercial and logistics backgrounds," he comments. Ghani believes that ultimately demand for BPO will have to come from the corporates to give banks the incentive to invest. However as Quinn points out, "Banks that think BPO involves a major technology investment should know that we, and others, can provide a private label service."

THE FUTURE FOR LCS

Assuming BPO achieves its projected rate of adoption, will it ultimately replace the letter of credit? Quinn thinks that while BPO may take over a significant volume, a residual market for LCs will remain. "There will always be a need for document-based instruments since the weakest

link in the supply chain defaults to paper. For example a freight-forwarder in India may not have the electronic technology to translate LC forms into data. Also, while BPO can accommodate a large percentage of documents, there are some that are unique to a particular trading partner and are not worth institutionalising unless or until there is sufficient demand."

Ghani feels that given the complexities of the global supply chain, BPO – at least at first – may be limited to more straightforward transactions. "The classic challenge in business is getting rid of paper, but this is difficult to do from end-to-end, because there are always exceptions and the devil is in the detail," he argues. "BPO will most likely have to be implemented in bite-sized chunks." ①

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