

Mitigating Risk, Maximising Opportunity for International Trade

Until the financial crisis of 2008, global trade was being conducted increasingly on an open account basis, with SWIFT estimating the figure to be around 80-85%. The rationales for open account trade are clear: it is convenient and helps lower cost. During and subsequent to the crisis, however, treasurers and finance managers increasingly recognized that despite its convenience, there are challenges associated with the open account model, both for buyers and sellers, particularly relating to liquidity and risk. As this article outlines, there is now the opportunity to mitigate these risks while still capitalizing on the advantages of open account trade. The answer comes in the form of a new financial instrument called Bank Payment Obligation (BPO) through SWIFT's centralized automated data matching engine – Trade Services Utility (TSU).

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The advantages of conducting trade through open account

An open account transaction means that goods are shipped and delivered to the buyer (importer) before payment. As the relationship between trading partners matures, conducting trade through open account can offer substantial benefits to both the buyer and seller.

First and foremost, buyers can reduce underlying costs associated with trade flows, specifically those relating to bank fees. Turnaround time also improves as a result of straight-through-processing, which in turn facilitates cash forecasting and liquidity management for both parties and reduced need for external credit facilities. Moreover, both parties are also able to cut down operational requirements as a result of less trade-related documentation.

As enticing as it sounds, there is a variety of challenges associated with open account transactions. To begin, while the buyer stands to benefit from improved cash flow and cost-savings, the seller faces the risk of payment delay or default after the shipment of goods. As such, it is not easy for the buyer to convince the seller to trade on open account terms based on their own credit rating. In some instances, the buyer may need to provide a standby letter of credit as security, which increases overall cost. Some sellers may also require buyers to assist with financing the trade flow as a form of risk mitigation. Operationally, there could also be additional administrative requirements such as reconciliation of payment information with purchase orders.

Likewise, the seller also faces a variety of open account trade-related issues besides those associated with risk management and payment. At the top of the list are securing financing and identifying ways to remove receivables from its balance sheet.

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The case for TSU and BPO

In response to the trend of open account trade, SWIFT launched a bank-to-bank platform called TSU through which pre-defined data extracted from trade-related documentation, namely the purchase order, commercial invoice, insurance and transport documents, can be automatically exchanged and matched. Essentially, TSU is a centralized matching engine aimed at providing automated data matching in a timely and accurate manner.

In 2009, this SWIFT initiative was given a boost with the introduction of a new financial instrument called BPO, which is an irrevocable undertaking by the obligor bank (buyer’s bank) to pay a recipient bank upon successful matching of agreed data within TSU.

TSU, paired off with BPO, have immense potential in today’s operating environment as a risk mitigation tool offering cost and operating efficiencies to trading partners. This is possibly best epitomized in the signing of a ‘Declaration of Cooperation’ between SWIFT and the Banking Commission of the International Chamber of Commerce (ICC). In effect, the declaration paves the way for the acceptance of BPO as an alternative means of settlement in international trade, providing the benefits of a letter of credit in an automated environment.

While the benefits offered by a BPO and a letter of credit are similar, there are fundamental differences between the two. The key difference is that whereas the letter of credit relies upon the physical checking of complete sets of documents, BPO utilizes automated matching of selected data elements in accordance with the agreed baseline.

Figure 1 provides an illustration of the TSU-BPO process compared with a traditional letter of credit arrangement.

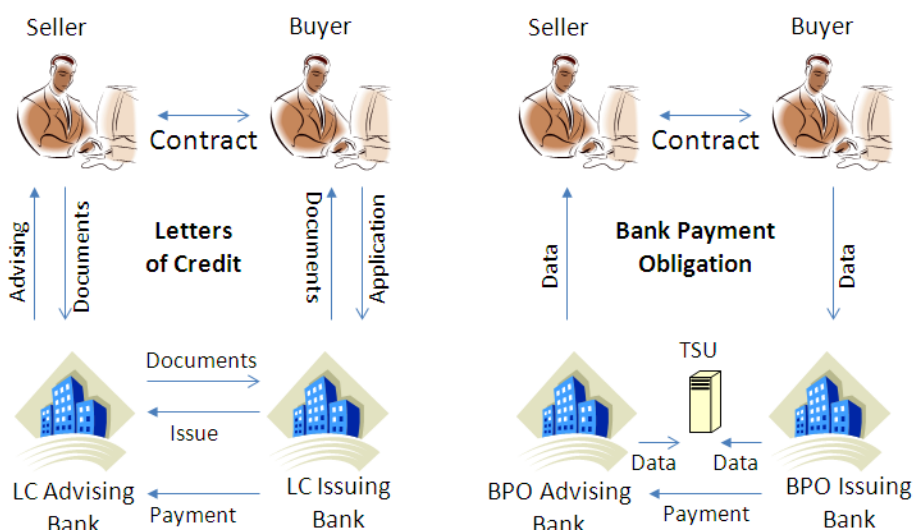


Figure 1: TSU – BPO compared with letters of credit

A differentiated service that benefits buyers and sellers

In tandem with this development, J.P. Morgan has deployed a TSU-BPO solution that will help clients – both the buyer and seller – enhance their open account trade flows.

For buyers (importers), J.P. Morgan's TSU-BPO solution provides the opportunity for securing more favorable payment terms capitalizing on the presence of an irrevocable payment obligation. As the TSU process is handled by J.P. Morgan, buyers do not need to invest in additional technology or resources to use the solution. Cost of a TSU-BPO transaction is lower than that of a letter of credit transaction. Documentation is handled more efficiently, with discrepancies identified and resolved promptly, accelerating the exchange of cash and goods. Finally, buyers also do not need to provide sellers with a standby letter of credit as the BPO can be issued per purchase order or per shipment, and is paid only against compliant transaction data.

Likewise, sellers also reap similar benefits in terms of risk mitigation, greater cost and operating efficiencies from using J.P. Morgan's TSU-BPO solution.

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Moreover, in instances where J.P. Morgan acts for the buyer and the seller, the firm can offer further value-add services such as providing the buyer with electronic copies of documentation for more accurate data matching and the seller with document preparation services.

Growing interest in TSU-BPO solutions

TSU-BPO's promise of risk mitigation, greater cost and operating efficiency is drawing traction globally over the past year. So far, early adopters come mainly from the communications and energy sectors.

Looking ahead, J.P. Morgan expects to see a gradual but steady climb in takeup across a wide variety of industries. In addition, we also expect more banks to join the TSU initiative, which will help accelerate the adoption of BPO globally as an alternative payment means.

With volatile economic conditions expected to persist and pressure on working capital management optimization to mount, the role of TSU-BPO in trade finance is poised to gain further momentum in 2012 and beyond.

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