



## Letter of Credit Discussion

50 years ago the "Letter of Credit" or similar documentary credit instruments secured the vast majority of global trade. Now, in stark contrast, 70% of global trade is performed on an "open account" basis without any risk mitigation instrument in place. The decline in use of the Letter of Credit was so rapid that only 5 years ago many banks and industry analysts were predicting the complete demise of the LC instrument. At the same time there was a flurry of activity around possible new replacement instruments mostly fuelled by the dot-com and "internet-solves-everything" frenzy. None of these alternates have gained broad industry acceptance.

In fact the use of the LC although it has diminished substantially has now stabilized and in many areas is increasing, if not in volume terms, then definitely in value terms. This strengthening of the instrument is partly driven by the extension of global supply chains to those regions which are still very LC dominated (China being the best example) and partly due to the realities of the total 180 degree shift from the LC to open account and the loss of control and increased risk this entails.

The shift from LC to open account has been driven by a number of factors; the principal two being:

Improvements in supply chain management thinking for certain industries has changed the relationship between buyer and supplier from adversarial, lacking of trust to a closer supply chain partnership based on preferred suppliers, shared business processes and loyalty or longevity in the buyer supplier relationship. Not all of these partnerships are entirely symbiotic, many still being driven by a power buyer who can dictate practise to its supplier base.

Cost and inefficiency. The LC is a very cumbersome, expensive paper based instrument that historically provided the main source of trade finance revenue for a bank. Its very inefficiencies resulted in increased bank charges (53% of LC are rejected at first time presentation to the bank) tiresome administration and delays and bottlenecks in an increasingly lean supply chain. For the bank it represented a lucrative source of fees.

Although buyers and suppliers wanted the certainty and protection of an instrument such as the LC, the costs and inefficiencies combined with the shifts in supply chain relationships almost guaranteed the migration we have witnesses over the last 5 years.

It is very interesting but probably not that surprising that faced with the administration complexity of the LC, the focus of automation by the banks has been to provide message standards which are inter-bank only directly benefiting the banks but not the parties whom the instrument was designed to serve, the banks' customers.

Efforts by the banks to improve the LC for corporate customers have been mostly self-centred to reduce the costs to the bank. Although there has been some attempt by the larger banks to provide value added LC services to their corporate customers, these still primarily meet this paradigm making it easier for the bank to provide straight through processing (STP) into the bank's

back office systems rather than providing any ability to consolidate or integrate on the corporate side. In addition the fixation most banks have on competitive differentiation has resulted not in the convergence on standards for their corporate customers, but rather the reverse wanting to deliberately engineer proprietary technology, standards and services in an assumption this will lock in customers and provide differentiation and competitive advantage.

For those many corporations who deal with multiple banks (large, medium and small) such increased LC automation provided by the bank is, paradoxically, more of a burden than a benefit unless the corporate is dealing predominantly with a single bank. In all other circumstances the corporate has to handle different technology platforms with different standards through different Internet portals, with different user interfaces and workflows. Because of the bank-centric nature of these platforms, the corporate has to go to each bank's technology platform to request or download an electronic LC. The "electronic LC" mostly being a non computer-readable text file or a fax or email attachment.

For the corporate this is only marginally better than paper and in many cases is actually much worse as the corporate has to invest in resource to understand each bank's platform and still has to end up printing the LC out as a manual document.

But corporates have three emerging requirements at odds with the way these services work:

- Trade Finance, Treasure and other departments charged with financial responsibility for the supply chain and the company's working capital increasingly need to have a consolidated view of LC's across all banks
- Increasing need to automate the incoming LC data directly into the company's back office systems without manual re-keying of data.
- The need to automate the creation of documents required for presentation to the bank in order to get paid, and in order to substantially reduce the cost and time involved due to discrepancies and rejections on presentation to the bank.

With current bank-centric solutions, to attempt to achieve any of these requires some combination of manual re-keying into the corporate systems and expensive investments in proprietary integration to each bank's LC formats. Some corporations have built hard interfaces to their major banks but normally only in the US where older EDI technology is the main electronic messaging platform used by banks.

Once a corporate stands back from this bank dominated historical process it is clear to see that a fundamentally different approach can preserve the bank infrastructure whilst simplifying and automating the process for the Corporate and delivering to all three objectives above. Indeed the pressures are building and clearly the main banks are not taking the initiative to provide open standards and common multi-bank services for their corporate customers.

Market demand from Corporates requires the following:

Externalised LC standards aimed not at the inter-bank requirements, but on the corporate use of the LC and the supporting Corporate to Bank collaborative processes. Although related to the

SWIFT standards used inter-bank, these standards are derived from the corporate use of the LC and the processes which operate at the corporate and its community on fulfilling the whole lifecycle of the LC. Bolero is at the centre of this externalised standardisation of the LC docs and data.

Availability of a true neutral multi-bank internet platform which fully supports these standards and the document flows as structured electronic documents, enabling easy “on-demand” automation of the whole lifecycle of the LC between a Corporate and its import and export side banks.

With these in place many of the disadvantages of the LC are removed. There is no longer any cumbersome paper documents, there is a common standard and automation of the entire process together with a substantial reduction of the potential for discrepancies, minimising loss of time in the supply chain and reducing costs associated with this instrument. The bank gets reduced fees as there are less discrepant documents that need to be re-submitted and indeed less need for manual document checking, but they had already come to terms with this revenue stream declining as the LC was increasingly abandoned.

Interestingly, had banks taken a proactive approach to the standardisation of the LC for the corporate customer, rather than trying to lock in to their proprietary services, the use of the LC would most likely not have declined so fast and their fees from this instrument would be more secure. Now the power has shifted to the corporate that is increasingly driving necessary change in this area.

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