



# Reducing Risk Through Bank-Assisted Open Account

Written by Bottomline Technologies  
and David Hennah of SWIFT

This article was first  
published by GTNews

Despite the recent credit crisis, globalisation continues its march. Now that it has become common for a corporate supply chain to span multiple geographies and jurisdictions, there has been a fundamental shift in how global trade is conducted. Recently published research has found that traditional bank-assisted trade finance instruments, such as letters of credit (LCs), now fund less than 10% of global trade. Based on a recent analysis of messaging volumes and values, SWIFT concluded that the indicative market share of world merchandise trade for LCs had fallen to some 9.3%, while the indicative market share for collections was a mere 1.4%. This data reveals a clear and continuing corporate trend to conduct cross-border trade through direct open account, thus increasing the opportunities for the adoption of innovative supply chain solutions that complement traditional trade finance.

Traditional documentary trade finance instruments continue to have a role within global trade, but experts recognise that open account will provide the core framework for cross-border trade during the next 10 years. Financial supply chain (Ibid) automation is the key enabler for many of the current trade financing initiatives, delivering significant cost reduction and risk mitigation. An increasing number of banks are offering solutions that streamline their corporate customers' purchase order (PO), invoice and dispute resolution processes. These solutions help automate the FSC and provide compelling reasons to settle cross-border trade transactions through bank-assisted open account.

## Example of Risk

Cross-border open account transactions are susceptible to supplier performance and fraud risk for the buyer, and credit risk for the supplier. In November of 2009, Agility, a Kuwait-based company that is the principal food supplier to the US military in Iraq, was indicted on charges that it defrauded the US Government in an US\$8.5bn fraud and conspiracy case. The complaint accused Agility of filing false invoices, failing to pass along discounts, and asking vendors to decrease the amount of products in their packages. Although an extreme case, the need for controls within the FSC to mitigate risk is clearly highlighted.

What would have changed had Agility employed FSC automation? Each PO presented would have been agreed to (as a baseline) by all trading counterparties, including the buyer's bank and the seller's bank. Consequently, the invoice and goods delivery data would have been compared in an open account match and any exceptions found placed into financial approval workflow. Had the approval process occurred electronically and on a per-transaction basis, the buyer would have benefited from total visibility.

Implementing process controls is important, but does this guarantee recourse? Existing trade instruments, such as LCs, have well-established and accredited guidelines, with dispute resolution procedures built around the Uniform Customs & Practice (the latest edition being UCP 600) as published by the International Chamber of Commerce. If banks are to offer automated cross-border open account services, they must ensure new rules, standards and widely accepted market practices are put in place.

## A New Trade Instrument

Together, the banking community and SWIFT have developed a new trade instrument called a bank payment obligation (BPO) to address open account counterparty risk. A component of SWIFT's Trade Services Utility (TSU) platform, the BPO builds on the legal structures available through existing trade instruments and combines those structures with the benefits of open account transactions and automation.

The BPO provides valuable assurances to both buyer and seller. Similar to a LC, the buyer's bank issues a conditional irrevocable guarantee to the supplier's bank. It is subject to the obligations of pre-determined conditions and the matching of data at various points in the trade cycle. Both buyer and supplier are guaranteed that payment will only occur upon an open account match. The BPO will likely be endorsed by the International Chamber of Commerce in 2010, further enhancing its credentials for cross-border risk mitigation and financing.

The BPO creates a compelling case for corporates to process their cross-border open account trade through banks. The framework provides improved visibility and control, effectively creating a risk-mitigated transactional trade platform. This secure cross-border environment unlocks exciting possibilities for automated trade or supply chain finance (SCF).

## Post-shipment Finance to Meet Liquidity Demand

SCF is the next-generation model for both domestic and cross-border trade. The recent financial crisis has highlighted the need for corporates to ensure the financial stability of their supply chain. This has led many large corporations to seek solutions that provide financing options for their small- and medium-sized supply chain counterparts.

To meet this supply chain liquidity demand, many banks are now offering post-shipment financing or 'reverse factoring' programmes. In the reverse factoring model, banks use an investment-grade, buyer-approved payable to offer discounted early payment to the supplier base. The supplier optimises working capital through inbound cash flow and reduced days sales outstanding (DSO), while the buyer benefits from extended trade credit terms, increasing days payable outstanding (DPO). These post-shipment finance programmes are successfully injecting much-needed working capital into the corporate supply chains earlier in the process, but remain reliant on the ability for buyers to approve invoices quickly.

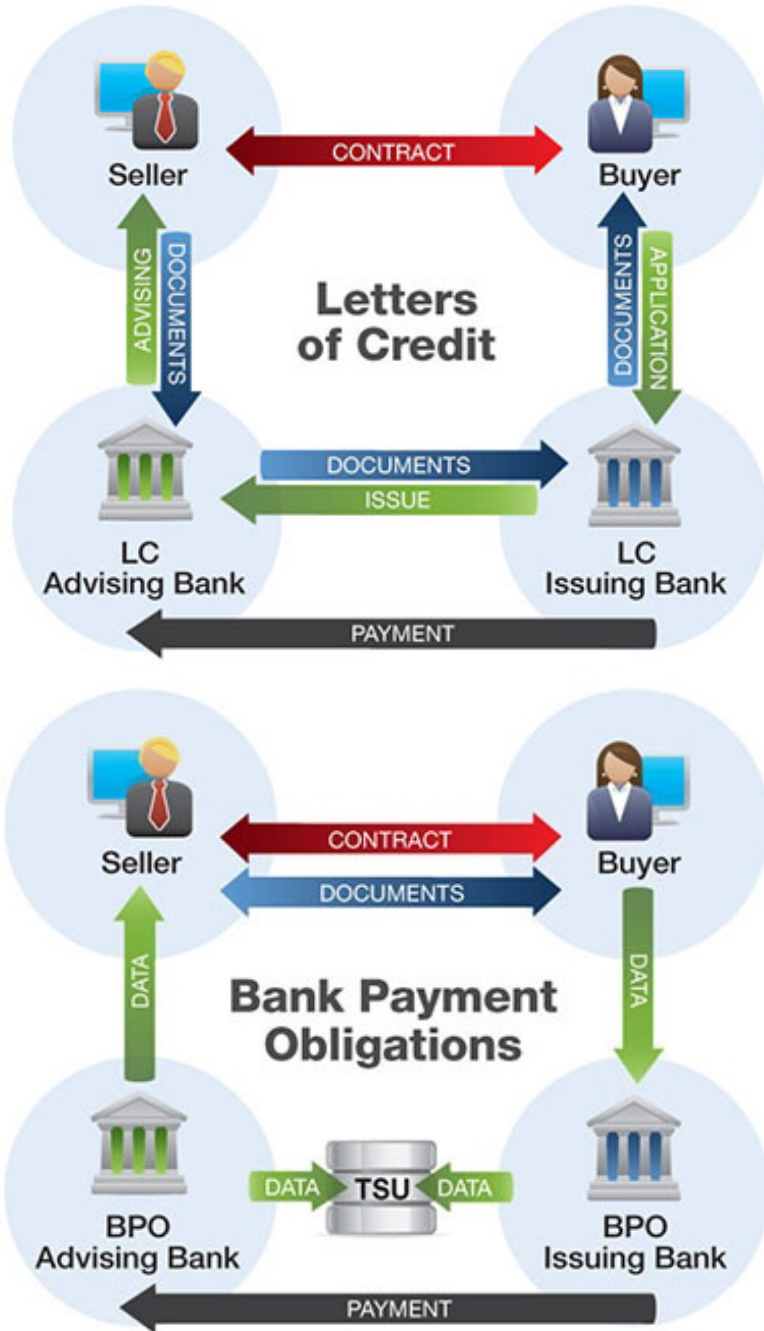
## Pre-shipment Finance to Support Production

Pre-shipment finance models offer greater benefits to exporters looking to support their suppliers. By ensuring suppliers have access to less expensive working capital earlier in the trade lifecycle, buyers can facilitate a reduced cost of capital for their suppliers, ultimately leading to a lower cost of goods. The following process highlights how banks can alleviate supplier performance and fraud risk with increased adoption of BPOs, allowing both the buyer and seller bank to offer innovative pre-shipment finance models.

1. The buyer's bank enters PO data into SWIFT's TSU.
2. The supplier's bank submits PO data, creating a 'baseline PO' agreement between counterparties.
3. A BPO is secured by the buyer's bank, representing a conditional irrevocable guarantee to pay the seller's bank, according to the terms of the underlying baseline PO. This is contingent on the data being logged with the TSU demonstrating a match with the corresponding commercial invoice and transport data.
4. Backed by the BPO and based on the supplier bank's experience and judgment of the supplier's ability to fulfil the contract, the supplier's bank now has improved visibility and a lower risk profile.
5. The bank can now advance a percentage of the PO value to finance the purchase of raw materials and/or manufacture of goods.

Once a BPO is logged by the buyer's bank, both the buyer and supplier banks are enabled for pre-shipment finance. The buyer's bank can choose to finance the transaction itself or leverage the geographic knowledge and presence of the supplier's bank. The supplier's bank has conditional assurance of payment through the BPO and can implement localised pre-shipment or post-shipment finance programmes. The BPO provides the supplier's bank additional comfort that invoices will be settled at maturity and, due to the risk transfer to the buyer's bank, enables the supplier's bank to offer competitive pricing.

**Figure 1: SWIFT's TSU Utility**



## Conclusion

Today, open account pre-shipment trade finance is not the standard, but with the onset of FSC automation, BPOs and the increasing reach of supply chain networks, it is likely to become the de facto trade finance standard in the coming decade. As the benefits of FSC solutions become more widely understood, supplier adoption of payment and invoicing networks will increase. However, any chief purchasing officer is familiar with the oldest rule of business - 'caveat emptor' (buyer beware) - and while membership in an electronic network does not necessarily guarantee a stable supplier, it does greatly improve FSC visibility, control and efficiency.

Banks are providing supplier assurances by monitoring the information supply chain along the purchase-to-pay (P2P) process. Each supplier's performance is measured over continual open account trade lifecycles, and a trade rating is then established for each supplier. This exposure helps banks mitigate supplier risk and enhances existing short-term credit ratings. Banks are in a good position to build these key supply chain networks, due to well-established customer relationships and geographic penetration through their sophisticated trade relationships.

Although the majority of cross-border open account trade is conducted corporate-to-corporate, evidence suggests that a significant percentage will migrate to a bank-assisted model over the coming years. The current model clearly places performance and fraud risk onto the buying organisation, while the supplier maintains credit risk. With the advent of global FSC solutions, banks have positioned themselves as a creditable arbiter. By allowing banks to process their cross-border open account transactions, corporates reap the rewards of automation, reduce counter-party risk and gain access to new financing options that will provide opportunities to compete for the next decade and beyond.