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# LCs and open-account financing: the dichotomous world of international trade finance

**IN THE LAST** decade, the trend in trade finance has been towards open-account trade and away from traditional documentary credits – driven by what are now established relationships between buyers and sellers as well as the diminishing number of minor players in a given industry. The operational efficiencies of open-account trade, versus the time-intensive nature of letters of credit, are so compelling that it is easy to understand how open account has become the method of choice for more than 85% of the world trade market. What may not be so easily understood are the reasons why thousands of merchants continue to use LCs.

For foreign companies doing business in Asia, the vast potential presented by low-cost manufacturing, an abundant labour force and vast markets is offset by an ancient dilemma, most aptly expressed in the Chinese character for opportunity, which combines the symbols for risk and reward. When weighed on the scales of world trade, they translate to a matter of balance; of how best to mitigate the risks for counterparties within and outside Asia, in order to reap the rewards. Indeed, the scales are further tipped by the differences between emerging-market economies and the developed nations that are their trading partners (language, infrastructure, technology, legal/regulatory, etc). However, the opportunity is not to be underestimated. China and India alone, the two dominant markets, provide access to a marketing opportunity equal to 40% of the world population, controlling 25% of the global economy on a purchasing-power-parity basis and contributing more than 20% of the global GDP growth each year.

However, in order to maximise opportunities in this complex environment, companies must look to establish greater efficiencies in their supply chain management cycles. Ensuring visibility and transparency along the entire transaction chain can not only lower costs and shorten cycle time, but also diminish the risk of defaults in terms of non-payment. Trading partners need the support of a global financial partner – of a size and scale that can deliver cost economies through technological innovation, with local insight into the markets where you do business and effective risk-mitigation capabilities.

### A brief comparison of methodologies

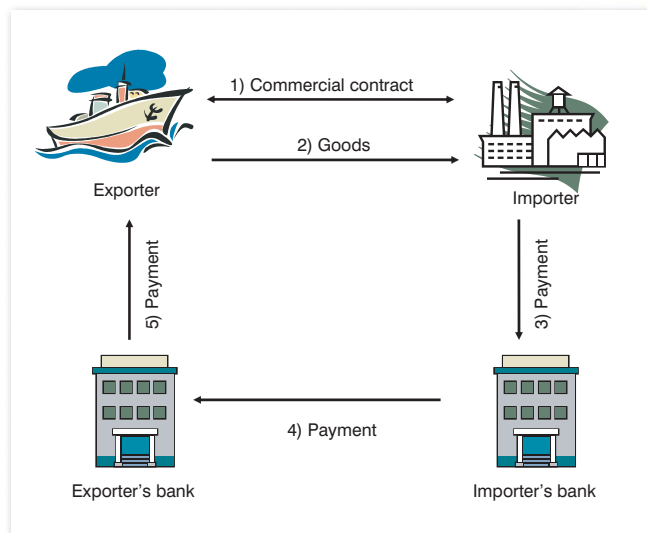
Open-account trade is a buyer-centric model essentially based on trust, usually the result of a long-term relationship between

the buyer and seller. The transaction is initiated by the buyer issuing a purchase order, which can be in paper or electronic form. The seller then submits the necessary commercial documents, and once these are confirmed, effects shipment. Once the buyer receives the goods, payment is made in the manner specified in the invoice.

As a key strategic supplier offering open-account terms, the seller is well positioned to sell the buyer more goods. The downside, however, is that the seller loses control over the goods and the payment timeframe, and is exposed to the buyer's risk of default. Banks play a significant role in open-account transactions by offering a range of financing options that can eliminate the buyer's risk of non-payment and provide the seller with on-time payment. (See case study 1: Open-account trade.)

An LC is a special undertaking issued by a bank, in favour of the seller, essentially substituting the bank's creditworthiness for that of the applicant (buyer) to enable the trade of goods or services. For growing companies engaged in global trade, they provide an effective risk-management tool, effectively guaranteeing payment by the buyer as long as the seller's documents comply with all the terms and conditions of the original LC.

Typically, international LC transactions require the services of at least two banks, one for each counterparty. However, with





a global network that spans 103 countries, Citibank is frequently the banker for both sides of a given transaction; issuing the LC for the buyer and advising the exporter from a single common operating platform –thus enabling faster access to the goods for the importer and reducing the working-capital cycle for the exporter. (See case study 2: LC and unknown counterparties.)



Nowhere is the central dilemma of foreign trade more concisely illustrated than in the Chinese character for opportunity, Ji-Hwei, which combines the symbols for risk and reward.

### The surprising durability of LCs

LCs may be the world's oldest financial instruments. Their use can be traced as far back as the 15th century BC, when Phoenician traders carried them to foreign ports in the form of clay tablets. Their ongoing viability over so many centuries is compelling testimony to the simplicity of their basic premise and the integrity of their intention – to substitute the lender's creditworthiness for that of the applicant, in order to pay for a shipment of goods or services from one party to another.

Today, however, it is estimated that only 15% of world trade is transacted through the use of these instruments. Although this would appear to be minor in terms of the overall market, the essential role they play, particularly in the case of emerging markets, far outweighs their dollar value, which in actual numbers is not so easily dismissed at an estimated \$1.23tn.

### Reasons for continuity

The built-in guarantees of LCs play an important role in the growth and profitability of international trade and are a key component in its expansion. First and foremost, they provide an effective risk-management strategy, enabling thousands of companies worldwide, which might otherwise be shut out, to engage in international trade. But complying with the rules of these time-proven instruments is of critical importance and requires knowledge, patience and an adherence to detail that is often missing in a new or expanding environment.

### Unravelling the mystery of compliance

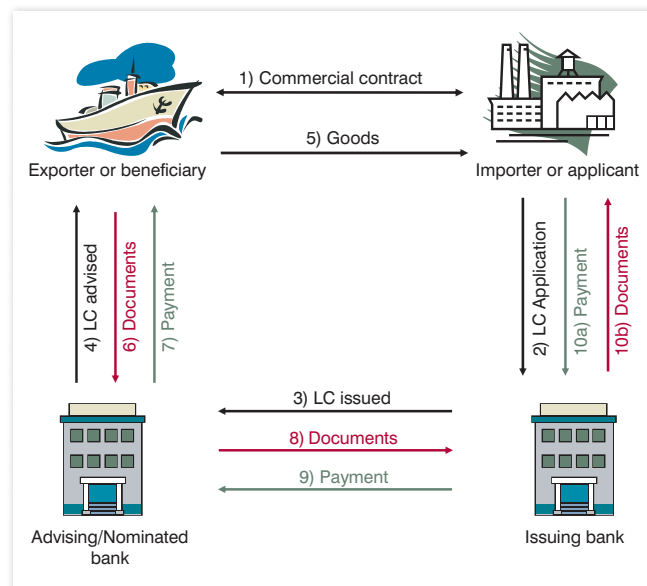
For the most part, the decision about compliance is based on the banks' understanding of the Uniform Customs and Practice for Documentary Credits (UCP), a document published by the International Chamber of Commerce (ICC) and incorporated by reference into almost every commercial LC issued globally. While more knowledgeable practitioners may understand the language

of the UCP, it is open to misinterpretation among the rapidly growing ranks of those less experienced – not only importers and exporters, but insurance companies and carriers, as well as the banks themselves.

Because the role of documentary credits in emerging Asian markets is not to be underestimated, Citibank has approached the problem on two fronts:

First, by actively participating in organisations such as the ICC to enact corrective measures. For instance, Citibank co-chaired the ICC task force which developed the International Standard Banking Practices for the Examination of Documents under Documentary Credits (ISBP). Industry-wide adoption of the ISBP is expected to reduce the discrepancies and confusion around LC documentation, which will speed the flow of payments to exporters and documents to importers, and enhance straight-through-processing for the banks.

Second, by providing a variety of services to customers to mitigate the problems of export document preparation. For



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example, our export-document outsourcing solution, Citibank Electronic Documents, is designed to assist exporters in reviewing the workability of the LC as well as the preparation of export documents.

In addition, the bank offers to buy the receivables on a without-recourse basis. With credit lines at major local banks worldwide, Citibank removes the commercial risk of non-payment for the local issuing bank, as well as the country sovereign risk from the exporters' balance sheet. (See case study 3: Financing and multi-currency solutions.)

#### **Choosing the right programme – open account or LC?**

The decision to try a new way of doing business is invariably driven by need and opportunity. For some companies, the switch to an open-account trade programme responds to both issues, offering tangible benefits for both buyer and seller. Buyers find they are able to decrease banking and internal processing costs, and reduce working capital, while sellers are able to increase sales. Their savings per transaction can be significant – as much as 80% in many instances.

Open-account trade is an ideal payment solution for buyers that have established relationships with their sellers; however, this payment method is primarily for long-term relationships with well-capitalised vendors. Conversely, newer or smaller vendors may choose to continue using LCs and migrate to open-account trade at a later date, based on the comfort level and needs of both parties.

#### **Optimising banking relationships**

The move from an LC to an open-account trade relationship is a complex undertaking that can affect both the company and its vendors.

Typically, companies start with a pilot programme, based on identifying a limited number of vendors that would yield the largest dollar volume of purchases and selecting the countries that are representative of the vendor population. A sampling of 20 or 30 vendors in as few as four countries (eg, Hong Kong, Taiwan, Malaysia and the United States) might be the first phase. Fully implemented, the programme would comprise a much greater proportion of the company's import volume.

Although reduced costs are an important incentive, keep in mind that this is the beginning of a long-term relationship. You want to be sure the package is wrapped in world-class service delivery with a provider that has a historic commitment to providing trade services. (See case study 4: Automation of buying-office operations.)

#### **Looking forward**

Regardless of the mechanisms used for conducting international trade, the critical aspects of document handling and the provision of information will continue to be the universal requirements for any international payment service. Both areas have great potential for redesign using current and developing technology.

In the world of open account, buyer/vendor relationships tend to be more strategic than with documentary credits. Sellers not only continue to take on traditional performance risk, in terms of quality and on-time delivery, but must also assume expanded financial risk, in terms of the buyer's ability to pay. As a result, the need for risk mitigation and funding increases. Financial institutions must meet these challenges, not only with state-of-the-art technology, but also with risk-defeasance techniques, supported by a thorough understanding of the client and the industry. At Citibank, these include supplier finance, receivable discounting/purchases, inventory/warehouse finance and credit insurance, as well as portfolio or name-by-name risk mitigation. In addition, we work with export credit agencies on the development of mitigation structures.

In the world of documentary credits, the relationship is dictated by the transaction, and the seller is under pressure to comply with every detail of LC regulation in order to collect payment. Although technology will continue to play a significant role in expediting document preparation, merely facilitating document preparation or information flow does not provide a true value-added service. For both importers and exporters, banks must fulfill an equally critical need to have the information verified, consolidated and relayed in a useable format.

Although the age-old equation of risk and reward will always play a significant role in every trade decision you make, we believe that the choice of an experienced financial partner with a large global footprint, multinational expertise and deep local connections is still the best way to tip the scales in your favour.

At Citigroup, the issues of language, local law and business customs are the basic ingredients of our global infrastructure. All over the world, our people are trained to conduct business consistently, in the native languages of our clients, with experienced country experts available for advice and information. In the context of world trade, this means an uncommon ability to tip the scales for our clients wherever in the world they do business.



## Case studies

### Case study 1: Open-account trade

A general merchandise retailer with 1,500 store locations and upwards of 10,000 transactions per year in its programme wanted to shift as many vendors as possible to open account. As a multi-billion-dollar retailer, they anticipated the company and its vendors would realise cost savings of \$3.5m in the first full year of operation.

#### Solution:

In the words of a senior treasury officer, "With our open-account trade programme we get savings on every level; first by reducing the volume of paperwork, second by reducing the need to utilise our credit lines, and third by decreasing our costs for reconciling and settling thousands of international purchase orders. Furthermore, because we can implement the open-account trade programme over our existing LC credit processes, there is no need to reinvent and relearn our internal processes."

### Case study 2: LC and unknown counterparties

When a mid-sized company in Hong Kong made a deal to export raw materials to a novelty manufacturer in Bangladesh, they were not familiar with the Bangladesh manufacturer and asked their bank to confirm the LC, to ensure they would be paid by the importer.

#### Solution:

Because Citibank was able to take on the risk and confirm the LC, either through a branch office in Bangladesh or a local correspondent bank, the exporter was able to do business for the first time with an unknown counterparty.

With the largest proprietary network in the world and more than 3,000 correspondent banks, Citibank is well positioned to help clients to expand into new markets, negotiate with new partners in risky environments and minimise risk while remaining competitive.

### Case study 3: Financing and multi-currency solutions

A global provider of software and IT-enabled services had long-term service contracts with hundreds of multinational corporations worldwide. They wanted to be able to collect funds in multiple currencies without managing local accounts. Currently, they were discounting their receivables without recourse. They needed a solution that would allow them to centralise funds collection, take the receivables off their balance sheet and mitigate credit risk to the buyers. In addition, they wanted to be able to use some of the proceeds to pay on-site expenses.

#### Solution:

The company opened an account with Citibank New York for consolidating all inflows. They were able to remit to bank accounts in various countries through CitiDirect® Online Banking, Citibank's online banking platform with the balance remitted to the home country.

### Case study 4: Automation of buying-office operations

The Hong Kong-based buying office of one of the world's largest contract manufacturers of apparel, with revenues of \$1.5bn wanted to integrate its LC vendor relationships with an automated purchase order (PO) warehouse system. They needed to update their POs automatically, and group them together based on pre-defined logic, with the flexibility to change them, at their discretion, prior to the creation of the LC application.

#### Solution:

By combining the warehousing solution with CitiDirect Online Banking, the buying office was able to streamline back-office operations, particularly in terms of time spent preparing and amending LC applications. Their authorised vendors were able to access the system to check their own POs and LCs – effectively eliminating calls to the buying office. The buying office could review the status of all LCs online, resolve discrepancies, retrieve various export bills presented by vendors, and work with treasury to authorise and initiate payments.

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