

Making Importing Easier and More Cost Effective for Small Businesses

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This article explores how small businesses can now import goods in a more efficient way, reducing risk and minimising costs. Banks wishing to strengthen their product offering in the small business sector can quickly deploy a trade services lite solution. This enables the secure exchange of trade documents over the web, integrated with an efficient international settlement capability.

With the growing trend of globalisation, corporates of all sizes are increasingly sourcing goods from suppliers far from their traditional home markets. This is driven by the now common practice of 'lowest cost country sourcing', a willingness to go greater distances to purchase goods or services at the lowest possible cost. The Internet, advanced communications and ease of travel have opened up new opportunities for importers and exporters to do business with distant counterparties. This trend will continue, particularly in times of recession, due to the basic economics of cost advantages.

In this new global environment, trade finance banks are redefining their value propositions to meet the evolving needs of their business customers. Banks are increasingly delivering value to their customers by using the web to provide cost effective solutions which ensure transactional control and risk mitigation.

Trade Finance Defined

Trade finance is a big topic, covering the provision of banking services to support export and import activities. The key elements of trade finance are:

- Finance to bridge the working capital gap, improving cash flow for both exporters and importers and allowing the former to get paid quickly and the latter to pay later.
- Transactional control to mitigate risk, such as country risk and counterparty risk.
- International payments and collections, as well as foreign exchange services.

Transactional control is one of the principal advantages of trade finance instruments. For example, an importer using a letter of credit (LC) knows that their bank will only pay away funds if the

exporter presents specified documents, which demonstrate that the required goods have been shipped, hence raising the degree of certainty that the correct goods will be received in a timely fashion.

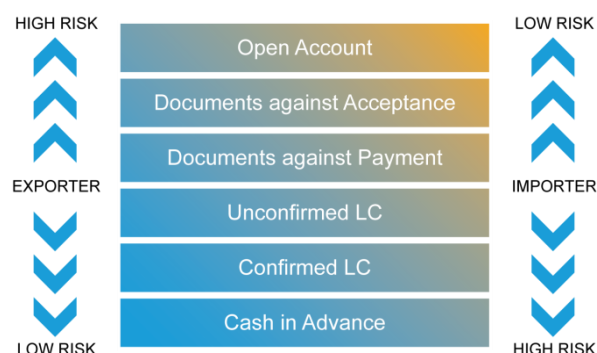
Importance of Terms of Trade



International terms of trade are generally agreed by the exporter and importer when a sales contract is negotiated. But the importer and exporter have naturally opposing views of risk and where a transaction is cross-border, understandably the level of trust, indeed possible distrust, about paying and getting paid is even higher than in domestic business. Terms of trade that are fully satisfactory to one party will probably involve high risk for the other party. For example, an exporter working on open account terms of trade loses control of the goods if they send shipping documents to the importer, who can then decide whether and when they settle the invoice. Open account terms usually require the exporter to have a high level of trust in the importer's willingness and ability to settle the trade debt.

This natural tension between buyer and supplier objectives can be illustrated as a 'risk ladder' (Figure 1), which shows the varying degrees of transactional control or protection for the exporter and the importer that are diametrically opposed.

Figure 1: Trade Finance Risk Ladder



Much has been written about large corporates and multinationals taking steps to streamline their financial supply chains and minimise the risk of buying goods from suppliers based in faraway countries. On a different scale, small and medium enterprises face similar challenges. Indeed, small businesses generally have fewer resources and lower expertise in managing the challenges of importing. Hence the major attraction of easy to use and low cost solutions.

In the difficult economic climate, small businesses are increasingly dependent on sourcing their supplies from distant markets such as China and India, driven by price advantages. Small distributors of engineering goods, consumer electrical goods and textiles in particular are importing from Asia. The average value of cargoes is estimated to be approximately £5,000.

Conventional Trade Solutions for Small Businesses

Traditionally small businesses sourcing goods internationally have been encouraged to use a range of international trade finance solutions:

- LCs.
- Documentary collections.
- Open account.
- Advance payment.

Letters of credit: benefits and drawbacks

An importer's objectives are to get the right goods at the right time, quality and price. They may be asked by their supplier to arrange payment by LC, since this provides the exporter with a high degree of security that they will get paid. When opening an LC, an importer is able to specify the documents that the exporter has to present to the advising bank, such as a commercial invoice and a bill of lading, which provide proof that goods have been shipped. An importer can ask for a pre-shipment inspection

certificate from an independent third party. This should ensure that the goods shipped comply with the order as regards quality and quantity. Thus an LC also provides an important measure of control and risk mitigation for the importer, as well as the supplier.

However, there are also disadvantages for an importer in using LCs. As soon as a bank opens an LC, it makes a commitment to pay and although this commitment is conditional upon presentation of documents by the exporter in compliance with the terms of the LC, this creates a contingent liability in the bank's books in the name of the importer, which is marked as a utilisation against the LC credit limit.

As the LC may have to be opened some months before shipment, an importer's credit facilities will be required to support this import transaction, rather than being available for any other credit requirements they may have. This utilisation of credit lines may create pressures on the importer's cash flow and working capital, particularly in the current economic climate.

In some cases, banks do not have the credit appetite for small business customers and are unwilling to make available credit lines to support LCs, without collateral. In this situation, a practical solution is for the small business to place a deposit with the bank as cash cover to guarantee the LC being issued by the bank. Hence, the bank has the additional cushion of the cash deposit as its source of repayment for the LC, rather than the business' general credit-worthiness. But this ties up the business' cash resources for the life of the LC, again possibly creating cash flow problems for the buyer.

In addition to the consumption of credit lines or cash deposits, LCs are complex and time-consuming to manage, requiring an understanding of the various steps required as well as the rights and obligations involved. Even once a bank has issued an LC, it is quite likely that the exporter will request an amendment and the importer will need to consider whether such amendments are acceptable. Furthermore, over 80% of LCs contain discrepancies and the importer will need to understand whether to accept or reject such discrepancies, albeit with advice from their bank. This can seem a daunting and over-complicated process for a small business manager who has little time for this administratively burdensome and specialised task.

Notwithstanding the security and flexibility of this trade finance instrument, LCs can involve high costs. In addition to fees for the opening of the LC, the importer will usually face charges for amendments, discrepancies and payment. Bearing in mind that banks apply minimum charges to LC, low value transactions are particularly costly compared to the overall price of goods being purchased. For goods costing say £5,000 an importer can be faced with bank charges of £200-300, equating to 4-6%.

This level of pricing has a massive impact on net margins for a small business and can mean that an LC is not viable in certain circumstances. It should be borne in mind that the supplier will also face charges from their local bank for processing a LC. These costs may amount to an additional 3-4% for advising an LC of £5,000. Clearly all these charges hit the bottom line and profit margin available to the importer on their sales, often making the LC a prohibitively expensive tool for a small business.

Inward documentary collections: benefits and drawbacks

An inward documentary collection is another trade finance instrument widely used by small businesses. Here the bank is involved in handling commercial and financial documents in a similar way to LCs. However, in the case of an inward documentary collection the bank does not provide the supplier with an undertaking to pay. As a result, the importer does not require a credit facility to manage an inward collection.

Inward collections have the additional advantage of being cheaper and simpler to administer than LCs. The importer does not have to make payment until they know that the goods have been shipped. In some cases, the importer may be able to obtain credit or deferred payment terms, by agreeing with the supplier that payment will be on a term basis, rather than on sight. This will usually be formalised by accepting a usance bill of exchange drawn on the importer by the supplier. The importer will have the opportunity to review the documents prior to authorising payment or accepting a bill of exchange. However, some suppliers will be reluctant to work with collections, preferring LCs as a more secure method of getting paid.

Open account

Open account is an arrangement between buyer and seller of goods whereby the seller ships the goods to the buyer and issues an invoice to the buyer that will be paid, usually after an agreed period of trade credit. This would appear to be the most attractive means of settlement for an importer, because it gives the importer control over when payment is made and the method of payment to use. This arrangement is also less expensive than LCs and inward collections. Given the high cost and time required to manage the LC process, small businesses generally prefer to use open account.

A major trend in recent years in international trade is the increased use open account, away from LCs and documentary collections. Recent research by major banks, such as Citi and Standard Chartered, suggests that open account now represents over 90% of global trade. This is a significant increase compared to earlier research by SWIFT, placing open account at over 80% of world trade. While the value

of LC business shows a gentle increase year-on-year, the volume of LCs issued each year remains flat, suggesting that the value of individual LCs is growing, reflecting usage by larger corporates, often in specialised industries such as commodities, for example grain and oil. It is also noteworthy that LCs are still mandatory in some countries where foreign exchange controls prevail. However, despite the significant advantages of LCs in specific circumstances, it seems that the trend towards increased open account trade is set to continue.

Advance payment terms

But many small business importers are unable to negotiate the full benefits of open account terms with their suppliers because it is difficult for suppliers to assess the credit-worthiness of small businesses. Overseas suppliers may therefore be unwilling to work on open account terms with small businesses. As a result, small business managers often find themselves obliged to agree terms such as paying all or part of the purchase price in advance. In favourable situations, this could be structured as one third with order, in advance of shipment, with an additional third paid on receipt of goods and the remaining third paid after a period of trade credit (say 60 days). This exposes the importer to the risk that the goods will never arrive or that if they do arrive they will not meet their requirements in terms of quality or quantity. Thus advance payments have high risks for the importer, especially where a 100% advance payment is required.

Cost Effective and Secure Alternatives to Traditional Trade Solutions

Thanks to web technologies and solutions for creating non-changeable documents, there is an alternative way to support secure trading by providing greater certainty and visibility for both the importer and their overseas supplier.

The simple answer lies in creating a secure environment for uploading, exchanging and reviewing trade documents. This solution is integrated with a low cost and efficient means of making international payments by linking into ACH networks across all major trading countries, hence providing a reliable and easy-to-use international settlement capability. The web-based exchange of trade documents, combined with an efficient international settlement network, come together neatly to form a trade services lite solution.

Based on similar principles to eBay, this is an online market place for small businesses where importers and exporters can order goods and arrange secure settlement. The online market place enables buyers and sellers to create, upload and review commercial documents as pdf images. These documents have the important advantage that they cannot be changed and they are proof of underlying transactions.

For example an invoice, shipping document can be uploaded by a supplier to demonstrate that goods have been shipped, in accordance with an importer's purchase order.

Early evidence of shipment: reducing risks

On receiving an order, a supplier creates documents on the portal or uploads pdfs of scanned paper documents. On the trade portal the importer can see images of these documents indicating that goods have been shipped, evidenced by a bill of lading. As a further security measure, an importer might ask for a certificate of inspection to be issued by an independent inspector at the port of loading, in order to confirm that goods have been shipped as ordered. This certificate of inspection can also be uploaded and viewed on the document exchange portal. A further layer of security can be achieved by requiring sight of a certificate of insurance, demonstrating that the supplier has insured the goods, if so required by the importer.

An important benefit of being able to view these document images on the portal is that it provides the importer with evidence of shipment much earlier in time than waiting for these documents to be delivered by post or courier. This in turn can accelerate the trade cycle, reducing risks for both the buyer and supplier. The importer has the comfort that goods have been shipped, with early assurance that they should receive the goods themselves shortly. This reduces the risk of late delivery of goods or even non-receipt of goods and provides the importer with greater confidence in winning new orders.

This structure is significantly less risky for the importer than the 'pay and hope' approach, whereby the importer sends an advance payment and relies on the supplier to send the goods on time, with no visibility of intervening steps in the manufacturing and shipment process. In the trade services lite approach, it is the importer who triggers payment to the supplier. Early visibility and confirmation of funds being available on a bank account gives the supplier comfort that they will get paid. It is possible for a bank offering this trade services lite solution to take control of the payment release against delivery of the required documents by the supplier. In this way, the bank can give the supplier a higher level of confidence that they will be paid.

Documents on the portal are securely held and can be used for audit purposes by all authorised parties. They can even be made available to third parties, such as external accountants, if appropriate.

Such a solution has many benefits:

- It is easy to use for busy managers of small businesses.
- It does not require any great expertise or extensive training, being intuitive and practical with a high degree of automation.

- The importer and exporter can exchange documents online easily and cheaply.

There is a compelling cost advantage for both parties since this trade services lite solution is less expensive than an LC, in terms of fees paid by both parties.

Payment assurance for the supplier

An online marketplace is also less risky for the overseas supplier, as they can see on the portal that funds have been placed with a bank by the importer in order to purchase the goods, hence giving the exporter greater assurance that they will get paid.

Re-intermediation opportunity for banks

Many banks want to re-intermediate themselves into the open account space by delivering value to small businesses. Banks can white-label a trade services lite solution as an on-line market place and offer this service to their small businesses. This provides banks with a fast route to market for re-intermediating themselves into open account transactions. It also recaptures payment flows from small businesses, which in some cases have been diverted to money transfer organisations. There is a readily definable market of small businesses importing low value cargoes from Asia. A solution of this type is low cost to launch and requires low maintenance for a bank, due to the largely self-service nature of the solution.

A bank could extend the product to offer escrow accounts in order to provide suppliers with additional comfort that they will get paid. This can be structured so that when funds are deposited by importers to pay for purchases such funds are released by the bank as soon as the supplier uploads to the portal documents demonstrating that the required goods have been shipped.

This approach benefits the supplier in giving them bank assurance that trade debts will be paid, since it is the bank that triggers the payment to the supplier, using funds already deposited in escrow by the importer. Similarly, such a structure should help importers negotiate lower pricing on their purchases, in the light of the improved risk profile for the supplier.

As regards to benefits for the bank, the use of funds held in escrow as cash cover allows the bank to mitigate its own risk against the importer when guaranteeing that payment will be made to the supplier against presentation of compliant documents over the web. This innovative solution becomes a new revenue stream for the bank. In addition, a bank can offer additional value added services such as foreign exchange.

The structuring of solutions whereby either the importer or bank are responsible for releasing funds to the supplier means that a trade services lite solution can meet the risk mitigation requirements of a range of scenarios.

In the first scenario, the importer is trusted by the supplier to release funds on sight of documents (evidencing shipment) over the exchange portal. In the second scenario, the bank, as trusted third party, is responsible for determining whether funds should be released, reducing the risk of non-payment for the supplier.

There is potential to link a document exchange portal with logistics providers. This enables importers to check progress of goods as they are transported to their destination. This tracking of physical goods helps mitigate risks for the importer.

The 'Utility' Business Case

Historically, banks have built their own trade finance solutions, either by developing a trade platform internally or by purchasing a piece of software and installing it in-house. But these science projects are usually based on a speculative business case, for example: "We need to spend X million US dollars to get Y thousand transactions per month," with a low and unproven ROI. In the current climate, such projects are less likely to get approval. 'On demand' solutions, hosted outside the bank but providing fast time to market and the opportunity to capture new customers, offer a compelling business case. Project risks of using a utility are low, as the solution leverages existing external infrastructure, with a low dependency on banks' own back office/IT structure. Furthermore for a bank who longer term prefers to host a solution in-house, the on demand model allows such an institution to move the solution in-house once the business case has been proven successful.

Undoubtedly banks are looking to minimise IT spend at the current time and are reluctant to embark on major new projects. So a new revenue opportunity where independent solution providers have already made the considerable investment in infrastructure to streamline the exchange of trade documents over the web and the efficient settlement of imports should have considerable appeal. Such solutions are now available for banks to leverage for the benefit of their small business customers, precisely at a time when governments and trade bodies are looking to the banks to improve their support for small businesses.

Achieving Low Cost and High STP Payments Globally

The key to an efficient international payments solution is to create a universal payments network, holding accounts with a selected group of international banks who are connected with automated clearing houses (ACHs). By opening accounts in each country, dynamic least cost routing can be achieved.

Establishing in-country bank accounts that link efficiently with local ACHs across more than 50 countries is an ambitious undertaking that takes time and effort. But once this infrastructure is in place, users can achieve low cost payments internationally.

Front end validation of payment instructions provides an extremely high level of successful routing, without manual intervention. This straight-through processing (STP) means that payments reach their destination as quickly as possible and at a low cost. This infrastructure is more efficient than traditional correspondent banking networks which can be slower, manual and error prone, so banks wanting to offer a competitive solution to their small businesses will find this approach a powerful value add to the trade document exchange. Similarly, the supplier has the advantage of receiving a unique identifier as a remittance advice which will greatly help reconciliation.

Complying with the Payment Services Directive

The challenges of achieving compliance with the Payment Services Directive (PSD) are causing headaches for many banks operating in Europe. As a key principle, they will be required to advise customers in advance exactly what charges will be taken by the remitting and receiving bank for processing a payment and also ensure that the full amount of the payment (without deductions) reaches the beneficiary account within a set timeframe. PSD compliance for euro denominated payments within the EU will be relatively straightforward, but payments within the EU in non-euro currencies are likely to prove more challenging for a number of banks. A universal payment network, linking ACHs, means the transparency and certainty benefits required by PSD can be achieved not just in euros but also payments in non-euro member country currencies. Indeed, payments to countries outside the EU can be achieved with equal transparency and certainty of price and delivery timeframe.

Conclusion

A low cost, easy-to-use and secure means of paying for imports has considerable benefits for small business importers, allowing them to be more competitive and efficient, while ensuring their suppliers get paid in a timely manner. Banks seeking to deliver value added services in the small business sector can now deploy such solutions with minimum cost and delay, creating new recurring revenue streams at minimum risk.

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