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Honing in on efficiencies

The financial crisis has honed companies' focus on working capital, beyond cash and liquidity management to also encompass their trade workflows. **Anil Walia**, executive director, Global Transaction Services, RBS says opportunities for corporates to re-engineer their processes and streamline their account structures to drive greater use of their cash have never been so promising.

Intense competition is rapidly increasing the pace of international trade, with buyers demanding faster order turnarounds and reduced inventories. At the same time, production is regularly being moved to new locations with lower costs. To survive, companies trading internationally must be more flexible, especially in exploring new avenues for streamlining their processes and cutting costs. Visibility and control over cash flow and financial information has become more important than ever before, and companies are seeking a model that better reflects the realities of a marketplace – one that handles paper as well as electronic transactions while providing an automated outsourcing solution without proprietary processes that require significant upfront investment.

Banks and technology vendors are increasingly focusing on collaboration in the financial supply chain, as well as developing tighter integration between accounts payable platforms and solutions for automating purchase orders, invoices and other forms of trade documentation.

Market drivers requiring change

With the recent financial crisis renewing the focus on working capital optimisation, the remit of some corporate treasuries has expanded beyond traditional areas of focus, such as cash and liquidity management. By understanding their company's trade workflow, corporate treasuries can identify the cash management benefits available across the entire physical and financial supply chain and better predict impacts to the company's financial outlook and balance sheet.

Because corporates are purchasers as well as sellers, they are seeking a closer integration between the trade and cash management areas. In many

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ANIL WALIA

smaller companies, these activities are already interlinked; however, in larger companies, integration of these functions has not yet taken hold. There are often departmental barriers in the management of different aspects of the same transaction. In addition, buyers and sellers have very different concerns. Incremental improvements in the order-to-pay process that result in releasing and redeploying trapped liquidity can have significant positive long-term effects. These include improvements in business processes, technological developments and integration with banks and other parties.

Collaborative solutions for buyers and suppliers

In order to recognise the benefits of an integrated cash and trade solution it is important to evaluate the supply chain from both the buyer's and supplier's perspective. Integrated cash and trade structures can enable trading partners to realise mutually beneficial solutions to common problems – for example, maintaining stability in the supply chain amidst the global financial crisis and its impact on international trade practices.

As a buying organisation, the purchasing division's objective is to get the right goods, at the right time, and at the right price. On a basic level, corporates have two types of transaction to process, those based on Letters of Credit (LCs) and the more streamlined open account transactions. Where credit lines are in place, banks can issue LCs and check the associated documents, as opposed to open account transactions, where no credit lines or guarantees are needed and the corporate will check their own documents in-house. Once any documentation is checked, and (if discrepant under the LC) the decision to proceed approved, payment is made via the LC issuing bank or, for open account transactions, the cash management bank.

The sales division negotiates the order with the buyer and coordinates the delivery time and payment terms. The buyer may issue an LC, which is reviewed to ensure a match with the original purchase order (PO) and this negotiation can be expedited by requesting bank financing, with interest charged by the bank. However the repayment of the LC will depend upon the bank's decision on the suitability of documentation presented under the LC, and whether the specified timescales were met. On the other hand, if the transaction is on an open account basis, repayment is dependent upon the payment mode agreed in the contract, and the willingness and viability of the buyer to pay. As open account transactions have become more commonplace, banks have also been providing more financing products, such as factoring, to service these transactions. However, costs are higher due to the risk profile of an uncovered transaction.

Optimising the financial supply chain

So how can the different organisations (banks and buying and selling corporations) be linked so that everyone can benefit from greater visibility of information? One method of coordinating this is through the Financial Supply Chain (FSC). Companies are looking for a model that better reflects the realities of a marketplace – one that provides both paper and electronic transactions while providing an automated outsourcing solution without having to plug in to a proprietary process that requires a significant investment in advance.

The FSC combines the challenges of trade financing and cash management, including the optimisation of the order-to-cash cycle for vendors and the procure-to-pay cycle for buyers. The FSC consists of building blocks that integrate with supply-chain systems and working capital management:

- Payment construction allows for the construction of the payment to be made for purchase orders originating from conditional and non-conditional open account trades as well as documentary credit transactions.
- Invoice management connects invoice processes and the bank, and allows for reporting on the status of the invoice and the creation of receipt rules.
- Order management also provides invoice status as well as the creation of payment rules for the processing of the purchase order.
- Agreement management enables the buyer to enter the contractual terms of a transaction.

Financing can reconcile the demands of buyers seeking to extend their payment terms and sellers pressing to speed up their receivables. Solutions could include documentary credits and bankers' acceptances, non-trade financing services such as factoring and receivables discounting, and e-payment services.

Integrated trade and cash management

In order to link trade and cash management processes, information must be organised at the start of a transaction. When a buyer's merchandising department issues a purchase order, the trade finance department should be informed of the details of the shipment, for example, the LC issue dates. The best way to coordinate all relevant information is electronically through an ERP system. Another possibility is to use a single bank system. For this solution to be successful the bank involved has to be willing to work with each seller, and must also have the geographic and legal capability to work with every one of its buyers. The drawback with this model is that all the buyers would still have to change their banking relationships and integrate with the same bank as their seller, as well as every logistics service provider, which could mean linking to hundreds of different shipping companies and consolidators.

One consequence of the financial crisis is growing interest among buying companies in maintaining the stability of their supply chain partners – while extending terms – through the use of supply chain finance. While the linkage of payables, cash and supply chain finance is undoubtedly attractive for corporates it has – until recently – been technically challenging. Traditionally, corporates uploaded files once a month detailing supplier payments to one or a number of banks.

Supply chain finance complicates this process because the buyer makes payment to the bank that has purchased the supplier invoice (and advanced the payment) rather than the supplier. RBS's integrated payables and supply chain finance solution simplifies this for the buyer, as only one payment file needs to be uploaded. Payments are divided into three pre-assigned categories: suppliers not in the buyer's supply chain finance programme; suppliers in the programme but not wanting early discounted payments; and suppliers that have chosen to take part on an early payment, discounted basis. The solution fully integrates cash management solutions with the bank's trade platform. Once the file is uploaded, the system manages and reconciles the payments. There is a single interface and a single channel for the three types of payments and the solution is adaptable for a variety of structures, including shared service centres.

Working capital management drives treasury agenda

Working capital management is now a board-level concern for companies – not least because of its impact on economic profit. Similarly, the management of credit risk associated with the financial supply chain is widely regarded as a priority for companies, helping to drive the uptake of supply chain finance solutions and discounted receivables programmes. As a consequence of the crisis, the role of treasury within corporates – and the centrality of key performance indicators within treasuries – has been enhanced, spurring increased strategic dialogues between banks, corporates and their vertical supply chains. The goal is to merge the financial and physical value chain.

Similarly, there is increased interest in bringing together the treasury and procurement departments to explore process re-engineering to improve transparency, increase STP and enhance cash application for a positive impact on working capital – and the income statement. Unlike many of the grand treasury projects of the past decade, many of the potential solutions to today's problems are – appropriately – extremely cost-effective.

Interest in Software-as-a-Service solutions is growing as internet security standards and technology are strengthened. Internet applications for invoicing and custom reconciliation and reporting solutions can be rapidly deployed for corporates and their vertical supply chains.

Overall, such applications are seen as a quick-win alternative to inhouse development of a corporate-specific infrastructure. Moreover, they offer the benefit of a cost-free infrastructure, guaranteed availability and data integrity. Many of the traditional barriers to efficient transaction processing have been reduced through SEPA solutions and their native XML format, increasing availability of e-invoicing, automation of paper-based payment instruments through remote capture solutions and online platforms for buyer and supplier information and approval exchanges. Opportunities for corporates to review and re-engineer their processes and streamline their account structures to drive STP and increase cash application – for the ultimate benefit of their income statement – have never been so promising. ■

A more secure alternative for open account

RBS has a long history of involvement with the Trade Services Utility (TSU), from senior-level participation in the influential Trade Services Advisory Group and leadership roles in regional TSU committees. However, the interbank initiative initially met with a lukewarm response. But with more than 100 banks now on board, **Madhav Goparaju**, Global Head of Channels, FI and Corporate Business Solutions and Supply Chain Finance at RBS, says SWIFT's ambitious trade initiative is gaining momentum and has the potential to reshape global trade.

SWIFT, the Brussels-based financial institution co-operative launched the Trade Services Utility (TSU) in 2007. It was the culmination of a consultative process involving many financial institutions that faced declining trade revenues as their corporate clients shifted from traditional documentary credits to open account terms. The TSU provides a framework for broader bank participation in open account trade, which now accounts for 85% of all global trade activity. It opens the door to processing open account transactions from their inception and holds promise for new supply chain finance and management services that will help companies enhance liquidity management.

At its core, the TSU is a bank-to-bank application for the exchange and matching of purchase order, invoice, shipping, insurance and certificate information in a standardised and secure environment. It leverages SWIFT's technology infrastructure, SWIFTNet, and uses the universally recognised ISO 20022 standard for XML messages. Unlike Trade for Corporates, a separate SWIFT initiative, the TSU focuses exclusively on bank collaboration for open account transactions. It does not venture into companies' back-office processes or how they interact with their banks. In many respects, the TSU mirrors the initial introduction of SWIFT messaging in the 1980s, when banks had to adjust to standard message types, straight-through processing and electronic data mapping. SWIFT messaging represented a major shift in the way banks conducted business with each other and their clients, which led to the demise of telex messages and reduced the use of paper-based letters of credit.

One standard, more flexibility

The TSU also corresponds with greater demand among companies for the exchange of trade transactions through non-bank trade platforms in order to achieve a single data standard across multiple banking partners. The introduction of more third-party platforms only compounds the problem of non-standard trade data as each solution uses a proprietary data format that does not communicate with other proprietary systems. The TSU provides a starting point for banks to agree on a data format and achieves the same results – data standardisation that permits straight-through processing with little or no manual intervention.

While some global trade banks have already built proprietary systems for open account, supply chain finance and data mapping services, companies can still benefit from the TSU. RBS anticipates that the TSU will facilitate and expand global trade. Currently, if a company sells on open account terms, it may have to deal with multiple proprietary banking systems. But if the company's bank is a registered TSU user, the company can just continue to work with that bank while its buyers work with their banks, with the TSU acting as a connection point for the exchange of information.

While the TSU may preclude the need for multiple banking systems, it will not eliminate them altogether. Large companies that want to push data directly from their back-office systems can interact with a variety of banks without having to use proprietary or multi-bank solutions through a mapping exercise. A company with fewer trade transactions may instead opt to use a proprietary channel and not perform any mapping, yet still avail itself of its bank's TSU services. The data standards employed by SWIFT through the TSU will make it easier for banks and ultimately their clients to exchange data without imposing the additional expense to manipulate files once the investment to establish TSU services is made.

A new trade instrument

The TSU's second release in 2009 featured the Bank Payment Obligation (BPO), an irrevocable obligation by a buyer's bank to pay a specified amount to a seller's (beneficiary) bank when there is a data match or when all financial institutions involved in a transaction agree to waive a discrepancy. The TSU mitigates risk between buyer and seller by involving banks in a transaction. Banks undertake KYC (Know Your Customer) compliance and, to a certain extent, payment risk is mitigated because buyers and sellers have some assurance that transactions will be paid if they are compliant.

Payment risk, however, is fully mitigated if a BPO covers a TSU transaction and shipping data matches the baseline (purchase order). For this reason, the BPO is considered the open account equivalent of a traditional Letter of Credit. For companies that want to do business on an open account basis, the BPO provides an extra level of protection that was formerly not available. Together, the TSU and BPO provide a framework that will enable banks, as the custodians of these information flows, to offer a variety of value-added services and alternative forms of financing, including pre-shipment and post-shipment, earlier in the transaction lifecycle.

Improved Working Capital Management – Because the TSU captures data elements specific to the physical and financial supply chain, it provides more transparency into the transaction lifecycle and allows for more informed decision-making. With information passing through their banks, companies will obtain a more comprehensive picture of their outstanding payables and receivables, which will, in turn, simplify working capital management.

Pre-shipment financing – By using data matching to assure payment, the TSU and BPO enable a seller's bank to provide pre-shipment financing for the production and shipment of goods. In

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MADHAV GOPARAJU

this way, the TSU restores a vital financing tool for exporters in emerging markets – the packing credit – which was lost in the transition from letters of credit to open account trade.

Vendor performance management – Electronic matching creates an unprecedented level of transaction accuracy. Discrepancies can be identified and corrected at an earlier stage, while supplier fraud can be averted.

Foreign exchange risk – Better monitoring of delivery and payment deadlines allows for more pro-active management of exchange rate risk.

Payment reconciliation – Standardisation of message formats facilitates the reconciliation of payments

Post-shipment financing – Financing can be predicated on the seller's limits/lines or upon a commercial match, in which case it is discounted with recourse to the seller.

The TSU will improve the interoperability of banks and may very well usher in a new era of correspondent banking in the open account space. For example, a third bank may guarantee a BPO obligor's payment much as it would when confirming a letter of credit.

There may be opportunities for shared, and possibly syndicated, financing between a buyer's bank and a seller's bank. In the case of pre-shipment finance, financing could be based on a BPO baseline match and risk would rest with the buyer's bank. In the case of post-shipment financing, risk would be booked on the obligor bank.

Working out the wrinkles

Many of the world's biggest banks have participated at the Trade Services Advisory Board level, undertaken various collaborative projects, including legal and accounting research, and shared their findings and recommendations. Independently, banks are developing their own TSU value propositions, with some deciding to take a Big Bang approach by connecting their front- and back-office systems to achieve straight-through processing from the outset, while others take a more conservative approach of running the application in a manual mode.

As they develop their commercialisation strategies, banks are grappling with how the TSU should be addressed in the context of credit, risk, finance, accounting, Basel II and even marketing. Additionally, a number of liability issues that are not addressed by the TSU Rule Book require time to research and resolve. It is a complex internal process that must be worked through.

New financial regulations and the overall tightening of credit favour a cautious approach, but we will get there. Many regional and second-tier banks, hesitant to make the costly investment to integrate the TSU into their back-office processes, are taking a wait-and-see approach. Other banks are exploring possible alliances that leverage a TSU-registered bank's interface and processing capabilities on a white-label basis. Many of our financial institution clients have approached us for further information and guidance.

Adoption of the TSU and the BPO, however, has been stalled by the lack of industry rules and standards outside of SWIFT's TSU Rule Book. In the absence of a universal regulatory and accounting opinion on the treatment of BPO, some banks are drafting agreements with other banks on which rules will apply, resulting in multiple disparate legal agreements that threaten to complicate and delay adoption.

Banks, on the whole, are looking to the International Chamber of Commerce (ICC) for BPO validation. The ICC's Uniform Customs and Practice for Documentary Credits, also known as the UCP 600, sets forth the universally accepted rules that govern global trade under documentary credits. ICC's endorsement of the Bank Payment Obligation concept would establish a foundation for adoption of a common set of guidelines and dispute resolution that would make the BPO a legally binding, valid and enforceable trade instrument. ICC accreditation would clearly be a catalyst for widespread BPO adoption.

Asia leads the way

Among the 102 TSU-registered banks around the world, Asia has assumed a leading role in both the adoption and adaptation of the TSU. Indeed, the first live BPO transaction was issued by a leading Chinese bank this past April. The bank is using the BPO to foster more domestic inter-bank trade. Historically, intra-bank LCs dominated domestic trade due to the lack of a unified telecommunications platform. The bank's decision to use the BPO was further supported by the TSU's local language capabilities, which support the input, transmission and matching of information in Chinese characters. Looking ahead, the banks plans to use the BPO as a framework for pre-shipment and post-shipment finance.

Looking ahead

RBS expects broader adoption of the TSU and BPO in the next 12 to 16 months, partly because SWIFT is recognised as a trusted and respected provider to banks worldwide. Our first priority is to promote awareness and understanding of the advantages of TSU and BPO among our customers. Once companies begin to understand how the TSU and BPO provide a more secure alternative for open account trade, establish buyer credit and reduce supplier fraud, there should be greater uptake. Moreover, once a regulatory framework is established, more companies will embrace the TSU/BPO, as they will understand how to account for it and treat it on their books.

Should the large corporates that have the SWIFT infrastructure in place for cash management and payment services leverage it for trade messages, they will gain from lower costs, greater STP and more accurate data transmission. This might also drive a new wave of standardisation and messaging tailored to companies' reporting requirements with a new corporate interface for open account transactions. ■