If you think the L/C is dead, think again

The letter of credit's obituary has been written many times before, but despite shortcomings, it survives. David Gustin explains why.

I remember being a young investor and hearing that the graveyards on Wall Street are filled with those that have been right too early. Well, I've been hearing the letter of credit (L/C) is a sunset product for what seems like decades, and many in the banking industry will retire on its use. It's easy and intuitive to believe the 'L/C is dead' theory.

Global Business Intelligence recently conducted detailed research on the international-procurement initiatives of major importers in North America. We spoke to some significant players and there's a good chance you are wearing something from one of these importers. Now, I consider myself to have a pretty good finger on the pulse of the industry, and even here I was surprised to find how embedded the L/C payment instrument still is. That's not saying that the desire to change is not there; it just hasn't happened yet.

L/Cs continue to be the dominant payment method for many major finished goods and retail importers. Why? We believe there are four primary reasons why large importers have not moved to open account (OA) quicker:

- **Liquidity and vendor financing** – Our research suggests that while vendor financing was a very distant secondary objective after other priorities in the purchase-to-pay cycle (i.e. the information flow, automation on the buyer side, etc.), it was the one thing holding back more of the larger vendors from moving to OA;
- **Compliance** – Usually a key variable in maintaining L/C terms for importers is customs compliance and the number of vendor relationships to manage. Compliance is critical to these companies. The L/C is much broader than a payment method; it can help manage the process of bringing goods and clearing customs;
- **Loss of control** – Disputes and loci of examination are two areas where the loss of control is an issue for vendors. Vendors know that if they comply with the L/C, they get paid. Under OA trading, short pays and merchant discounts can occur more easily. As to the loci of examination, OA moves it from the seller's bank to the buyer;
- **Internal systems** – Controls, processes and systems must be put in place by the importer. This takes information-technology resources and money, which are generally allocated to sales-growth initiatives.

This does not mean that the numbers will remain the same. Many major importers expressed a desire to move to OA terms with more of their vendor base and are taking action to do so. Our point is that it's not happening overnight.

So where does that leave banks racing to develop solutions to intermediate into this OA trade flow? Many banks will admit their customers want the L/C without the credit. It provides the rules of the game that are missing with OA and also is a way to outsource all the document handling and compliance. Don't be fooled by the value banks bring to compliance. Many of the larger importers/retailers check their own documents at least twice beyond what the bank does (at the global-sourcing office when preparing to release the inspection certificate and again in the accounts-payable back office). Importers don't like the fact that

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We found distinct classes of importers, and for those not building proprietary supply-chain business systems, the banks can play an active role in at least four financial-value-added areas for international trade. While this is not always about a straight-through process – bringing products into the country can involve high-touch processes –banks can help to alleviate the problems with the physical and financial flow of information not marrying up. The four areas are:

- ❑ Compliance verification – this will range from simple and automated to manual (i.e. text-based compliance);
- ❑ Vendor-financing capabilities;
- ❑ Vendor documentation;
- ❑ Reconciliation to back-end accounts-payable and other systems.

So while major importers in North America are not entirely happy with what they have, the fact is this is a slow process. Banks will need to approach their new solutions, not just from an efficiency play, but from one that can help importers with information about paying for goods and handling invoices and the status of the goods. It's agonising and frustrating to the bankers who thought that the market was ready for these solutions, but what's required is an understanding of major finished-goods cultures, business practices, vendor base, compliance and control issues and, perhaps most importantly, internal-systems issues and logistics. ❑

Percentage of overseas vendor payments done via L/C