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Deutsche Bank

Winter 2010

Crisis Spurs Letter-of-Credit Revival

While open account trade is clearly here to stay, the events of the past couple of years have called on corporate financial managers to reconsider the merits of the letter of credit (LC).

With the onset of the credit crisis and the subsequent global economic downturn, steady growth in trade volumes quickly turned to shrinkage. At the same time, liquidity from both banks and insurers dried up and funding surcharges rocketed, putting adequate short-term financing out of reach for many corporates.

As corporates have become more cautious regarding the financial stability of their trading partners, the LC has begun enjoying something of a revival. Indeed, many corporates have come to realise that documentary trade business offers more than just the paper and the data embedded within.

Recovery and Risk Transfer

Aside from access to goods, LCs offer a better potential for recovery in situations of distress, easier access to funding and cheaper funds — thanks to lower regulatory capital barriers — as well as risk transfer because the counterparty to the transaction is a bank. Given current market conditions, this method of calculating the cost of capital necessary to cover the counterparty and country risk has become an attractive alternative for cross-border risk management.

The costs of managing the paper trail and processing the documentation associated with LCs have fallen considerably over recent years, as banks and other service providers have developed tools to manage these processes more efficiently. LCs can now be initiated and monitored online, and electronic imaging has greatly sped up the process of examining documents for discrepancies. In this respect, the image of the LC as slow and prone to error is outdated.

The Complexity of Open Account

More often than is perhaps assumed, the operational and country risks associated with open account are not fully appreciated — since settlement requires elaborate vouchering, reconciliation and tracing processes. Also, the credit assessment of the counterparties to a transaction can be far from straightforward, requiring full disclosure and honesty from all parties.

Corporates need to ask themselves whether their own risk assessment and management capabilities are cheaper than paying the fees associated with an LC.

Despite the issues raised by recent events, trading on open account remains attractive, especially to large, well-funded purchasers. It enables greater integration between the physical and financial supply chains, provides greatly improved visibility and transparency, and can help generate additional liquidity within the value chain.

However, the problems that open account presents for suppliers also remain and, in many cases, have been exacerbated by the recent tightening of liquidity in many markets. Without an LC, many suppliers find themselves unable to offer strong security to their banking partner in order to attain working capital funding.

Part of a Broader Strategy

While some of these issues can be mitigated through the judicious use of financial supply chain management techniques such as supplier finance, many corporates — especially in emerging markets — may still experience difficulties when seeking to fulfill orders.

As a consequence, increasing numbers of corporates are now finding that the LC still has its place as part of a broader, more integrated, working capital and trade-risk mitigation strategy that involves both documentary-supported trade and open account terms.