

IS THE LETTER OF CREDIT LOSING ITS SIGNIFICANCE? A NEW PAYMENT METHOD IN INTERNATIONAL TRADE – BPO/BANK PAYMENT OBLIGATION

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Abstract

The head of the topics we qualified as ABC of international trade issue is the “risk” fact. Especially in order to avoid the risk of the companies which are traded firstly and the countries of these companies, and to guarantee the cost of goods more secure finance techniques are used. One of the main purposes of the companies involved in global trade is to increase market penetration, the other one is to take the cost of the sold good and service on time and safely. At this point, the economic power, geopolitical location and political stability of the countries which are imported and exported play important role in determining the mode of payment which is used in trade. In our essay, after a brief look on the payment methods used in international trade, we try to give information about BPO (Bank Payment Obligation), which is a new form of payment, in detail and comparatively.

Keywords: Bank Payment Obligation, Letter of Credit, Open Account, International Chamber of Commerce (ICC), Global Trade

AKREDİTİFLERİN TAHTI SALLANIYOR MU? ULUSLARARASI TİCARETTE YENİ ÖDEME ŞEKLİ – BPO/ BANKA ÖDEME YÜKÜMLÜLÜĞÜ (BANK PAYMENT OBLIGATION)

JelKodu: G21, P45

Özet: Uluslararası ticaret konusunun ABC'si olarak nitelendirdiğimiz konuların başında "risk" olgusu gelmektedir. Özellikle ilk defa ticaret yapılan firmalar ve bu firmaların ülkelerinin taşıdığı riskleri bertaraf edebilmek ve malın bedelini garanti altına alabilmek adına daha güvenli finansman teknikleri kullanılmaktadır. Küresel ticarete rol alan firmaların ana amaçlarından bir tanesi pazar penetrasyonunu arttırmak, diğeri ise satılan mal ve/veya hizmetin bedelinin zamanında ve güvenli bir şekilde alınması olmaktadır. Bu noktada ithalat-ihracat yapılan ülkelerin ekonomik güçleri, jeopolitik konumları, siyasi istikrarı, ticarete kullanılan ödeme şeklinin belirlenmesinde önemli rol oynamaktadır. Makalemizde, uluslararası ticarete kullanılan ödeme şekillerine kısaca bir göz attıktan sonra, yeni ödeme şekli olan BPO (Bank Payment Obligation – Banka Ödeme Yükümlülüğü) hakkında detaylı ve karşılaştırmalı bilgilendirme yapmaya çalışacağız.

Anahtar Kelimeler: Banka Ödeme Yükümlülüğü, Akreditif, Mal Mukabili(Açık Hesap) Ödeme, Uluslararası Ticaret Odası, Küresel Ticaret

1. INTRODUCTION

When the types of payment that are used in the global trade are analysed, it can be seen that prepayment based on collection and letter of credit has been used predominantly. To touch briefly on these types of payment;

1.1. Payment based on Collections

- Cash Payment, Down Payment, Advance Payment
- Cash Against Documents
- Cash Against Goods/ Open Account
- Cash Against Acceptance
- Cash Against Acceptance with Avail

1.2. Letter of Credit Types

In terms of assurance provided to the parties

- Revocable Letter of credit
- Irrevocable Letter of credit

In terms of bank that is responsible for payment

- Confirmed Letter of credit
- Un-confirmed Letter of credit

In terms of payment

- Sight Payment Letter of credit
- Deferred Payment Letter of credit
- Acceptance Credit Letter of credit
- Negotiable Letter of credit
- Revolving Letter of credit
- Green Clause Letter of credit

- Red Clause Letter of credit
- Transferable Letter of credit
- Back to Back Letter of credit

2. LETTER OF CREDIT USAGE IN TURKEY AND IN THE WORLD

Either both in global trade or and domestic trade, the target is to be taken the cost of sold product and/or service on time and safely. When the financial statements are analysed, it is observed that they use mainly bank credit because of having deficit in the time of cash cycle. One of the most important reasons for this is that trade receivables are not collected on time. (except for term extension due to the structural features of the sectors). Under the these circumstances, the firms which want to take place in the international scene, especially firms having export activities prefer letter of credit which is the safest payment type regarding to payment. Although operations in payment methods on the basis of collection are very fast, letter of credit comes into prominence since there is no any payment guarantee (excluding credit Against Acceptance with Avail operations) and payment guarantee is issued for letter of credits by banks.

However, it has not been said that the workflow of letter of credits is fast. Letter of credit is losing its importance gradually and an alternative or supplementary payment method is being searched due to being connected to several procedures, having reserve application, high paid commission to the banks for letter of credit operations, extension of process because of arriving documents are included in the letter of credit text through banks and many other reasons. The mathematical indicators of these searches can be seen from the following table easily.

Global Trade and Letter of Credit

YEAR	2000	2010	2020
GLOBAL TRADE VOLUME	6 Trillion USD	15 Trillion USD	33 Trillion USD
USE of LETTER of CREDIT	(25%) 1,5 Trillion USD	(18%) 2,7 Trillion USD	(11%) 3,5 Trillion USD

Source: TEB Paribas Partnership (www.teb.com.tr)

Turkey's Foreign Trade and Letter of Credit

YILLAR	2000	2010	2013
TURKISH FOREIGN TRADE VOLUME	82,3 Billion USD	299,4 Billion USD	403,6 Billion USD
USE of LETTER of CREDIT	(22%) 18,1 Billion USD	(18%) 53,8 Billion USD	(11%) 44,4 Billion USD

Source: TEB Paribas Partnership (www.teb.com.tr)

As it is understood from above tables, whereas global trade and Turkey's foreign trade volume increase, letter of credit operations volume rate tends to decrease proportionally.

According to 2013 data, the share of letter of credits from worldwide global trade is under 10 %. In recent years, according to an analysis of SWIFT messages, it is observed that 9, 3% of global trade is letter of credit and 1, 4% is cash against document payment methods. ??The remaining part is composed of cast against goods and it is also estimated that the shift to the cash against goods operations will continue the next 10 years. (Özalp, 2014)

While the area of the use of letter of credit is becoming narrow, volume of cash against goods is one of collections becoming effective thoroughly. When the following table is examined, the increasing rate of global trade shows parallelism with volume of open account

YEAR	2010	2020
GLOBAL TRADE VOLUME	15 Trillion USD	33 Trillion USD
USE of LETTER of CREDIT	(18%) 2,7 Trillion USD	(11%) 3,5 Trillion USD
OPEN ACCOUNT / AGAINST GOOD	(82%) 12,3 Trillion USD	(89%) 29,3 Trillion USD

Source: TEB Paribas Partnership (www.teb.com.tr)

3. CONCEPT AND FUNCTION OF BPO

BPO (Bank Payment Obligation) has come to light because of facilitation of international trade, sending the documents in electronic format (the legal infrastructure of electronic signature must be accelerated), elimination of payment insecurity in collections, and etc. BPO can be used both in international trade and domestic trade as well.

BPO, like other type of payment rules used in international trade, will also be subjected to the standard rules published by ICC (International Chamber of Commerce). In 2012, with a signed protocol between ICC and SWIFT, the writing of BPO rules started and as a result of the voting in ICC Banking Commission Meeting held in Lisbon, BPO was accepted and entered into force. Uniform Rules for Bank Payment Obligations (URBPO) put into practice for BPO by ICC, was implemented in 2013.

It is useful to go into more depth by the giving definition of BPO. BPO is defined as “A *Bank Payment Obligation (BPO)* is an irrevocable and independent undertaking of an Obligor Bank to pay or to incur a deferred payment obligation and pay at maturity a specified amount to a Recipient Bank in accordance with the conditions specified in an Established Baseline”. (Discussion Paper prepared by ICC Commission on Banking, document number 470/1204, page 3, 2012)

According to this definition, liable bank in other words Obligor Bank can or cannot be the buyer’s bank, however, Recipient Bank must always be the seller’s bank. (Özalp, 2014) To define actors involved in the above definition as follows will shed light on our further detailed explanations.

Obligor Bank : Liable Bank

Recipient Bank: Beneficiary Bank (always should be the seller’s bank)

Established Baseline: Established (was generated) Database

4. THE DIFFERENCE OF BPO FROM LETTER OF CREDIT AND CASH AGAINST GOOD OPERATIONS

For a better understanding of the BPO process, we believe that an explanation of difference between Letter of credit and Cash against Good (Open Account) will be useful.

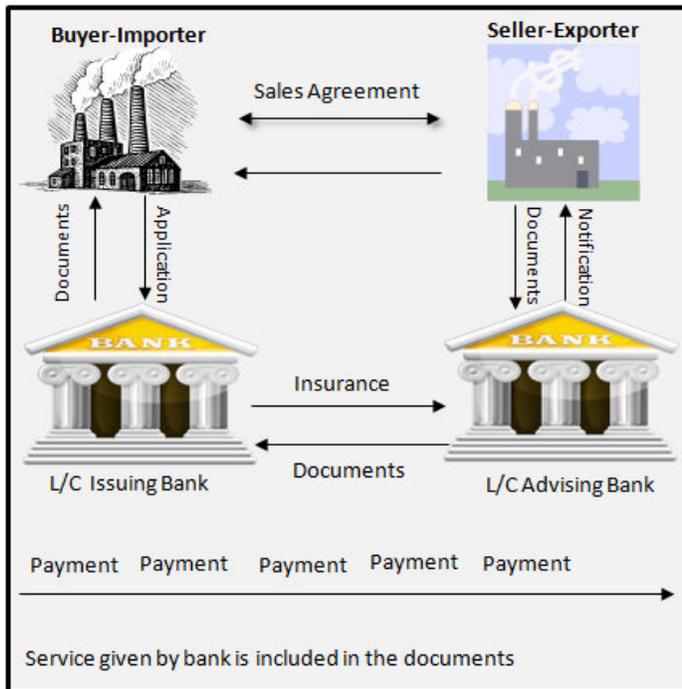
4.1. Letter of Credit Operation and Its Functioning

Buyer and issuing bank, seller and beneficiary bank, confirming bank and for some situation reimbursing bank are involved in letter of credit. Letter of credit operations subjected to UCB 600 brochure was published by ICC and must be made payment by bank.

The point to take into consideration here is that obligor banks to pay, will make payment as long as only suitable documents based on letter of credit should be submitted in letter of credit operations obligor banks carry into discrepancy implementation when unsuitable documents for letter of credits text are submitted (e.g. even a letter mistake of a word in the text) and this causes extension of workflow.

Moreover, banks can cut in the ratio of determined letter of credit's amount with discrepancy implementation.

Letter of Credit Work Flow



Source: SWIFT, Published Date: September 2012

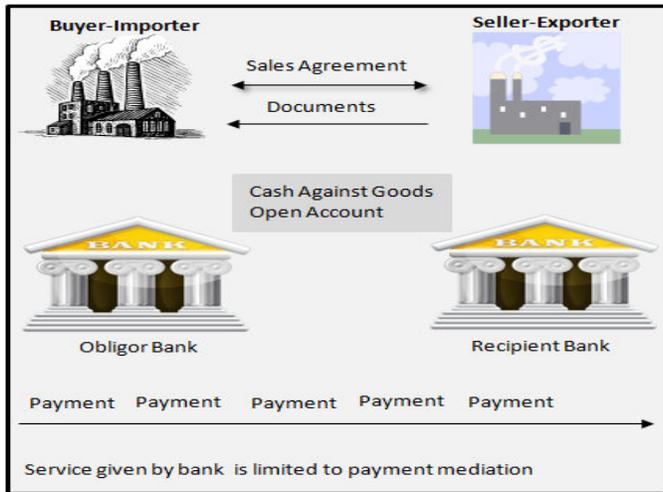
On the other hand buyer, seller, beneficiary bank and confirming banks take place in against good (open account) operations and the documents are transmitted directly to the buyer by seller. It has been seen in this kind of payment that banks only mediate for payment and they do not make a payment commitment.

4.2. Against Good (Open Account) Work Flow

As can be understood from the following table, documents are transmitted directly by seller to buyer for open account transactions. At this point, banks do not have any payment commitment but they can mediate for the payment. Against good transactions are more risky for the vendors. Since seller takes the price of good after he/she send them to the buyer by clearing through the customs. At this point, the major risks emerge associated with payment. Although a large portion of global trade is composed of against good transactions, they have great risks.

From the aspect of seller, because of the fact that the banks haven't made any examination on documents, taking the price of goods has a great risk; even though its transaction process is much faster than letter of credit transactions.

Against Good Work Flow



Source: SWIFT, Published Date: September 2012

4.3. BPO Workflow

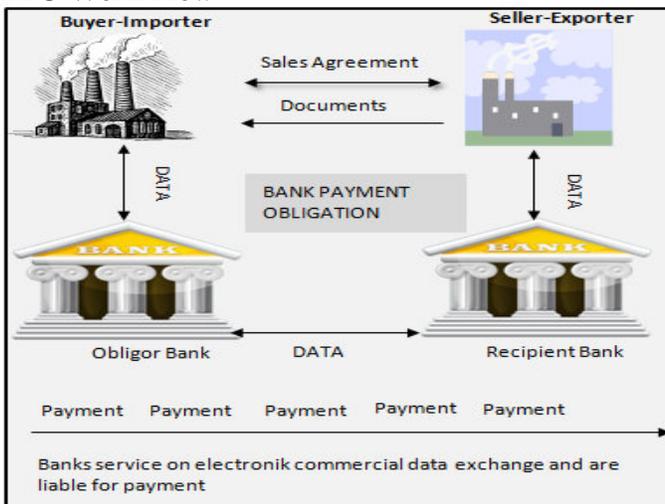
After examining the positive and negative aspects of letter of credit and open account (against goods), we examine also negative and positive aspect of BPO which melt these two process in the same pot in other words combines the payment guarantee in letter of credits transaction and process flow rate in open account transaction. The most important positive aspect of BPO is payment guarantee given by bank.

However, this guarantee unlike letter of credit is not a guarantee based on examination of physical documents. It emerges as a payment guarantee given as a result of matching data accurately and completely. In BPO, documents are directly sent from seller to buyer, as for electronic trade data is transmitted to buyer and Obligor Bank.

At this point, it is useful to further classify this issue. Intermediary bank for BPO transaction should establish Trade Service Utility (TSU) system which enables to match electronic commercial data.

Because making ready of Transaction Matching Application (TMA) constitutes fundamental part of BPO is very significant issue. TMA should generate a report besides matching electronic data. Since the reports generated as a result of matching is important for buyer, seller and Obligor Bank.

BPO Work Flow



Source: SWIFT, Publish Date: September 20112,

BPO Work Order

1. Within the commercial agreement between buyer and seller, firstly, a purchase order is send to the seller by buyer.
2. After this purchase order is accepted by seller, buyer informs Obligor bank liable for BPO operations about purchase order and BPO request.
3. At this stage, seller affirms the order specifications and BPO conditions to his/her Recipient Bank.
4. Informed and affirmed data given from buyer and seller are compared in TMA. If data is matched, the formed database is created. After this stage, both buyer and seller receive the match report from their bank.
5. After receiving the matching report, seller delivers goods to buyer (Transport)
6. After delivering goods, seller gives shipping documents and invoice information to his/her bank.
7. Seller's bank which has received shipping documents and invoice information transmits this information to TMA in order to match data.
8. Information coming from TMA is reported to buyer by Obligor bank. If there is unmatched part in matching report, the acceptance or rejection of this part is concerning with buyer.(At this point, this situation can be similar with accepted discrepancy which is emerged from letter of credit by buyer)
9. If the matching is accepted, Obligor bank informs Recipient bank about the success of matching. In this case, Recipient bank notifies to seller about this successfully matching.
10. Documents which are necessary in order that buyer clear goods from customs are transmitted to buyer by seller directly.
11. When payment due date comes, Obligor bank collects amount of payment from buyer, send this amount to the Recipient bank and Recipient bank pays the required payment to the seller. Thus BPO process is completed.

After examining the process step of BPO, it could be beneficial to examine also the advantages of BPO for buyer, seller and banks singly.

5. ADVANTAGES OF BPO TO THE PARTY OF PROCESS**5.1. Advantages for the Buyer- Importer**

1. BPO is more secure than cash payment from the buyer's perspective. Buyer is not obliged to make payment without receiving the document of ordered good. (hereby shipping documents has important)
2. Timed financial opportunity is provided for buyer.
3. BPO strengthens relationship between buyer and seller and guarantees the supply chain.
4. BPO extends the business opportunities and increase the competitiveness in foreign market.
5. Buyer confirms required specifications of good and whether it is forwarded on shipping date or before shipping date.
6. Buyer can configure payment according to his/ her requirements.
7. Buyer can negotiate for the better conditions. Buyer can prove its payment ability by using BPO and negotiate about the better condition for future transactions as well.
8. BPO increases income and decreases cost.
9. Buyer can take measures for inspection, quality control, production control and lead time in BPO system.

5.2. Advantages for Seller – Exporter

1. Seller can configure delivery schedule according to his/ her request, determine when payment will be made and similarly , when goods will be loaded
2. Foreign currency risk can be eliminated with BPO transaction which is arranged over valid currency in seller's country.
3. Buyer cannot avoid making payment by putting forward a complaint about good.
4. Automatic transaction process accelerates the payment and financial process.
5. BPO can be put into use at any stage of commercial transaction and wrong matches can be accepted.
6. Physical document eliminates the subjectivity (finding discrepancy) and reduces conflicts and delay time.
7. Automatic data matching reduces the level of complexity and improves the level of security
8. Bank bears responsibility for all faults that may arise at every stage of BPO.
9. There is a payment guarantee.
10. Flexible financial opportunity pre -shipment and post- shipment can be found.
11. Risk occurred in the payment of good's price passes from buyer to Obligor Bank.
12. Cancellation of the amount of order or reduction in the amount of order by buyer is not concerned.

5.3. Advantages provided to Banks

1. Low business risk
2. Prudent (cautious) usage of capital
3. Consistent commission and wage income
4. Creation of new business opportunities
5. Strengthening of intensive trade relations
6. Automatically Solution
7. Low operating cost

6. RESULT

Effective using of BPO system will take some time as globally and locally because there are available banks that prepare infrastructure of BPO in our country. One of them is Turkish Economy Bank (TEB) partnership with the BNP Paribas, the other one is Is Bank.

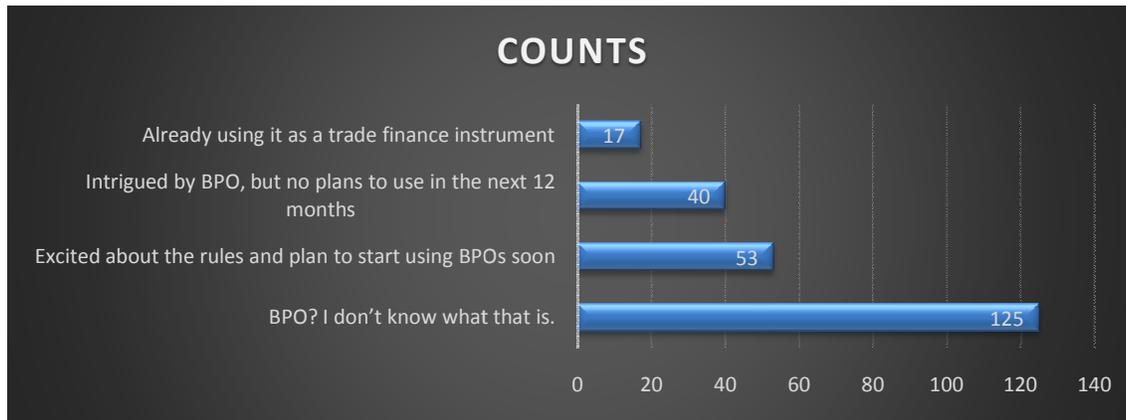
When we look at around the world, 55 banks which are preparing to switch BPO and 7 banks which apply BPO in practice are available.

There are few resources in existence that we receive detailed information about BPO. Mainly, we have been making use of published information notes of ICC, published documents of SWIFT and very small amount of articles as resources.

More attention will be attained as a result of expansion of the BPO usage and in a faster adaptation process. For instance, designated authority to apply during judicial process for conflicts, application area in domestic law and related issues are the leading issues should be discussed thoroughly. On the other hand, whether or not the perspective of banks on BPO is an alternative on BPO for letter of credit will be examined wonderingly.

To summarize, although BPO has similarity to letter of credit, it is completely a novel and alternative payment type which is a combination of the speed of against good transactions and the payment guarantee of letter of credit.

JP MORGAN Survey Results related to awareness of BPO



Source: www.jpmorgan.com

According to the result of JP Morgan's ongoing survey, the awareness level of BPO system all around the world follows a low trend.

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