Using a foreign exchange online portal in lieu of commercial letters of credit for small businesses in the international import arena

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ABSTRACT

Businesses understand the competitive advantages that can be obtained by participation in and utilization of global markets. Decreases in costs along the value chain, enhancements and expansion of product lines and the resulting market expansion in U.S. domestic markets as a result of import activities are well known for larger companies. But, can a small business function successfully in a similar environment? This paper discusses the possibility of small businesses functioning successfully in the international import market without the use of commercial letters of credit, banks as controlling intermediaries and with a large amount of autonomy with regards to the flow of foreign currency and contracts. Specifically, this paper examines the commercial letter of credit and contrasts it with the use of a foreign exchange online portal by small business. The paper shows how the online portal can be used to circumvent some of the compliance and financial problems associated with the commercial letter of credit and in lieu of commercial letters of credit for small business purchases.

Keywords: commercial letter of credit, foreign exchange, online portal, small business, international imports, international markets, entrepreneurial ventures

INTRODUCTION

For small businesses and entrepreneurial ventures, forays into the global arena to take advantage of opportunities that may enhance their domestic markets through direct imports from foreign countries presents an abyss that tends to thwart such actions and thoughts. Initial queries into the possibility of being a direct participant in foreign import activities typically leads to the mention of commercial letters of credit and the resulting bank financing associated with these documents (Allen, 2007). Small businesses may quickly determine that this is the way things are done since commercial letters of credit have been the secure bastion for commercial importation of foreign goods by large companies for well over a century. As they research the commercial letter of credit, it becomes apparent that this document in and of itself presents a maize fraught with its own complexities and extremely high initial failure rates from 40% to as high as 77% (Moses, 2006). Couple this with the underlying financial requirements, strict compliance factors and associated cost factors and you have a formidable required appendage associated with the original idea of importing products to enhance the domestic market of this small business or entrepreneurial venture. Needless to say, this tends to block further action along this visionary track in many cases. In other cases, companies pursue this activity using commercial letters of credit only to find delays and resulting cost overruns as a result of payment rejection that reduces the marginal revenue and the resulting profit margin of the items to such an extent that the benefit of pursuing the original global market is nullified. Consequently, unless these businesses have high liquidity and can handle these activities as cash transactions, they tend to opt out of extensive pursuit of this opportunity (Allen, 2009) (Leonidou, 2004).

An option for small businesses and entrepreneurial ventures is the use of a foreign exchange online portal[1]. This option coupled with a commercial line of credit is the basic framework for interacting successfully in the global import market. Using this configuration, the entrepreneur controls the foreign transaction from initial contact with the prospective exporter (vendor) through the final transfer of funds into the specified bank accounts of the foreign agents for purchase of the imported items. The approval of all contracts, agreements, bills of lading, broker negotiations, through final receipt of the goods is controlled directly by the entrepreneur (Wells Fargo Bank, 2004). The only bank intermediary position relates to the commercial line of credit and its use with the associated questions regarding application and use of the online portal. An extremely interesting aspect of the use of the online capabilities of this portal is the fact that it is typically free. In addition, essentially all of these activities can be handled online via the internet and by use of the telephone. This is in direct contrast with the handling cost and fees associated with a commercial letter of credit. However, the term caveat emptor stringently applies here since the entrepreneur or their agent handles the strict compliance factors in this environment. However, it is felt that the personal familiarity with the exporter, their agents and the agreed upon processes can reduce the costs related to the initial failures associated with the lack of strict compliance contributing to the initial failure of many commercial letters of credit with their underlying resulting costs (Rauch, Vol. 39, No. 4, 2001).

This study will review commercial letters of credit and the use of foreign exchange portals. It will compare some of the rejection points of letters of credit and compare and contrast them to the use of a foreign exchange portal. The purpose of the study is to compare and contrast the use of commercial

[1] The online portal described in this paper relates to the specific foreign exchange portal option associated with the Wells Fargo Commercial Electronic Office (CEO®) Portal (https://wellsoffice.wellsfargo.com) although similar portals exist within the commercial offerings associated with other financial institutions.

letters of credit verses the use of a foreign exchange online portal for smaller businesses and show how the online portal may be a better avenue for small businesses to use for international purchases.

THE COMMERCIAL LETTER OF CREDIT

A commercial letter of credit (LC) as defined in the U.S. Uniform Commercial Code (UCC) is an undertaking, usually on the part of a bank and at the request of one of the bank's customers, to pay a named beneficiary a specified amount of money (or to deliver an item of value) if the beneficiary presents documents in accordance with the terms and conditions specified in the letter of credit[2]. The crucial items relate to the fact that LCs are documentary based entities requiring that beneficiary documents comply strictly with the specific terms and conditions as indicated in the LC. These documents are required to be presented within a designated time frame stipulated in the LC. The bank then makes the determination whether or not the specific conditions set forth in the LC have been met. Any deviations whatsoever will cause the LC to be rejected by the issuing bank (Baker, 2008).

On the surface, this seems rather innocuous and straight forward. In practice, however, the process can become rather convoluted (Barnes, James G. and Byrne, James E., August 2008). There is a difference between how the process is supposed to work in theory and what can happen in actual practice (Klein, 2006). The document is rather complex and must conform to UCC Article 5 and the UCP (Uniform Customs and Practices for Documentary Credits) as well. In practice, the UCP is typically automatically incorporated into the LC. LCs are sophisticated tools of commerce and should have oversight by an attorney. As an example of these complexities, the following basic issues typically need to be resolved: 1) What is the maximum amount of the drawing or credit liability, 2) What is the expiration date of the LC and should there be an "evergreen clause" that extends this time frame and if so, in what circumstances and by what amount, 3) Is the credit revocable or irrevocable by the customer, 4) What documents are included for required commercial credit payment, i.e. a bill of lading, a commercial invoice, a draft or bill of exchange, a consular document, an insurance certificate, or an inspection certificate, 5) Where should these documents be specifically presented for payment, 6) Can the commercial credit as confirmed by the bank issuing the LC be also confirmed by another bank which actually can become the major player in these negotiations. These are a few examples of some of the options available (Bobrow, Adam et. al., 2002). A breach of any specifics related to any aspect of the document from the prospective of the issuing bank generates a rejection with ensuing failure of payment. The bank makes this determination unilaterally based upon the customer's specifications in the LC (Barnes, James G. and Byrne, James E., August 2008).

It becomes readily apparent that to eradicate non-compliance and the resulting rejection, the customer needs to educate themselves regarding LCs and limit the number and complexity of the documents required for compliance to only documents essential for completion of the transaction. It is imperative that the customer make certain that documents that are impossible to fill in a timely manner are not included in the specific request for documentation. Although this sounds like a given, it does occur. Vendors need to ensure that all data is transcribed correctly and directly from the commercial documentation. Finally, it is recommended that an attorney be hired (Bobrow, Adam et. al., 2002). The idea is to simplify the documentation without breaching the security of the agreement understanding that the final compliance determination will be made by a third party.

[2] Unless otherwise stated, "LC" refers to a commercial letter of credit, "UCC" refers to Revised Uniform Commercial Code Article 5, and "UCP" refers to the Uniform Customs and Practices for Documentary Credits, 1993 and 2007 revisions (International Chamber of Commerce Publication Nos. 500 and 600).

THE SMALL BUSINESS DILEMMA

LCs obviously have their place in the global business arena and are and have been a critical and valuable asset for the purchase and transfer of goods and services for many decades. In the case of large international purchases, especially in the $20 to over $100 million range, they may be unavoidable (Davidson, D.V. and Saubert, R. W., Fall 2007). In this case, the associated fees are just a cost of doing business and help assure that the goods and services are identified and actions performed exactly as indicated for global transfer and payment for these expensive items. In the case of larger firms, their legal staff and possibly foreign offices help assure the feasibility of these transfers. The use of multiple banks may help assure that the ability of the purchaser, and in some cases the initiating bank, to pay, the funding is secure and the funds are transferred in a timely manner with the corresponding foreign exchange transactions an integral part of this process (Bobrow, Adam et. al., 2002).

What can be done for the small business owner who wants to take advantage of these global opportunities as well? Can he/she operate in this environment with the security necessary to make certain that the same or similar assurances exist? Can this also be done without the complexities, fees and commercial misunderstandings that lead to a rejection of the LC with the underlying costs and possible legal actions that are many times associated with such rejections? Many of these costs stem from the fact the bank, as a third party and in some cases multiple banks being involved, are not intimately familiar with the agreements and the resulting flows which were an integral part of the original negotiations (SITPRO, 2003). In addition, many of the small business purchases are well below $1 million and many below the $500,000 point.

In today's markets, many small business and entrepreneurial venture owners travel to foreign markets with the specific purpose of finding and negotiating deals directly with foreign vendors. As such, the business relationship, especially over time, becomes a strong bonding factor in these negotiations. This is not to say that an astute business person is not fully aware of the downside of any business negotiation and that the international environment enhances this downside risk. Yet, there are still safety factors that can be applied if the purchaser understands this environment and can find an avenue to protect their investments as well as the investments of the vendor. The safety of this process can be assured to an extent that may approach if not surpass a LC, if the owner can find the correct venue and support that can be applied in this environment (Chevalier, Joseph et. al., 2008).

A package and scenario exists without incurring some of the costs and downsides associated with the complex LC (Wells Fargo Bank, 2004). This does not mean that the business person negotiating and overseeing these transactions cannot be judicious. Some time will have to be invested in learning not only the international markets, foreign currency flows, caveats associated with certain countries and especially the cultural negotiations and factors associated with doing business in a foreign environment. However, the cost of such information is front loaded with adjustments and experience reducing the costs associated with such negotiations and actions over time. The following section will present one such possibility that can be and has been used in a small business environment with direct control by the business owner and little interaction of third parties in a unilateral position to impair the process as a result of lack of personal knowledge and the relationships associated with the transaction. Transaction security is still present for both the purchaser and the vendor and is controlled to a major extent by the customer to the benefit of the vendor.

THE FOREIGN EXCHANGE ONLINE PORTAL

Small businesses and entrepreneurial ventures can manage foreign transactions and agreements with foreign vendors without the need for LCs and involvement of banks as unilateral partners and the resulting costs associated with these arrangements. The small businesses need access to an online foreign exchange portal (Wells Fargo Bank, 2004) and an underlying pre-approved commercial line of credit from the partnering bank that is documentable to the foreign vendor very similar to the confirmed purchase order process (Chevalier, Joseph et. al., 2008). This small business' commercial line of credit (LOC) should be at least equal to and in most cases in access of the amount being negotiated for the purchase of the international goods. The LOC cost to establish is typically minimal and negotiable in many cases. With the LOC, either all or a portion thereof is activated at the discretion of the customer rather than the commercial note associated with the LC which is typically activated at the discretion of the bank.

The foreign exchange online portal allows the user to deal in the currency of the country in which the vendor is located. Typically, this online portal is a service of the bank which will be handling the commercial LOC. The customer (small business owner) can then purchase and hedge foreign currency in preparation for a future payment to the specified vendor. In certain situations the purchaser can take advantage of certain foreign currency fluctuations by purchasing the foreign currency before the international business transaction is completed to hedge exchange rates which may present a savings in purchase cost as a result of foreign exchange rate fluctuations. The transfer of these funds then will be in the currency and denomination specified by the vendor. Transfer will be in the form of a wire transfer or draft into a specified bank using the S.W.I.F.T. sequence reference number of that bank and account. The resulting interbank transfers can be consummated within 24 to 36 hours and confirmed by both parties including any foreign currency transactions (Wells Fargo Bank, 2004).

This activity can actually be a hybrid between a pre-pay and open account option which are used in lieu of LCs. In the pre-pay option, the purchaser pays for the international goods up front before they are shipped. This option is good for the vendor but obviously puts the purchaser at risk. The result is that most buyers shy away from these types of transactions. In the open account option, the vendor sends an invoice along with the goods requesting payment for the purchase price of the goods. This is good for the buyer but places the seller at risk (Bobrow, Adam et. al., 2002). In each case, debt collections in foreign countries and jurisdictions are not options that are considered very attractive. For LCs as well as online portals, there are situations where these types of risk can occur. The imperative is to control these potential threats to the fullest extent possible in both situations. In the case of LCs, this is accomplished by documentation provided to the issuing bank. In the case of the online portal, it is accomplished by documentation provided directly to the business owner or owner's agent.

The fact that the purchaser is controlling the interactions associated with the funds flow and assessing the documentation flow personally makes this a viable option in lieu of the use of LCs for the small business owner. The timing of funds flow directly into foreign accounts within a short period of time can make this a hybrid between the pre-pay scenario and the open account scenario. Documentation of a viable LOC assures that the funds are available for the purchase. The item that makes this an attractive vehicle for foreign transactions and agreements is the fact that the owner is intimately aware of the intricacies of the original negotiations and agreements as well as the individual agents in the transaction process. As a result, the process moves from one of "strict compliance" determinable by a third party in the case of LCs to a "spirit of compliance" in this situation. Circumstances that will not necessarily cause a breach or action failure in the original agreement but may not be exactly as originally stipulated, such as not hyphenating a portion of a lot number for example, do not arise as a documentation breach which may be cause for payment rejection with resulting costs for a LC (Davidson, D.V. and

Saubert, R. W., Fall 2007). Included in these costs may also be the loss of goodwill which may have developed as part of the rapport from doing business with this vendor over time.

Due diligence must be followed by the small business owner relating to documentation such as bills of lading, inspection certificates, shipping documentation, insurance certificates and other items deemed necessary to assure that the business transaction is progressing as expected (Chevalier, Joseph et. al., 2008). There is no need for a specific termination date, as in an LC, that invalidates the document and resulting payments at the discretion of the issuing bank. In essence, there may be an expected performance completion date mutually agreed upon for the completion of certain aspects of the transaction but there is a perpetual “evergreen clause” at the discretion of the purchaser, rather than a third party, for situations that may be acceptable yet originally not expected.

The pre-pay/open account hybrid situation is based on how funds transfers are determined, in what amounts and follows closely the confirmed purchase order concept (Chevalier, Joseph et. al., 2008). Funds transfers may be made upon completion of certain milestones in the transaction process allowing for partial payments on the part of the purchaser for successful completion of these events. The customer only needs to access that portion of the LOC associated with the completion of that event. Of course, in any situation, it is rather difficult to defend against absolute fraud. In this case, the assumption is that this is a true arms length transaction with the absence or intention to commit fraud. In the case of funds transfer, these can be completed at any point or points and in amounts specified by the buyer and seller. Since, the time frame to send and verify amounts is very small, actual transfers can occur as desired. In essence, the purchaser does not have to pre-pay rather provide transfers based upon completion of certain milestones in the process verified by proper documentation provided to the buyer. From the standpoint of the seller, transfers can be accomplished at certain milestones in the transaction rather than waiting until delivery of the goods as in the case of an open account transaction. In this scenario, the buyer and the seller are in communication and events that occur are the result of communication, documentation, and the personal knowledge and rapport that exist between these agents (Chevalier, Joseph et. al., 2008).

CONCLUSIONS

The cost of agency and due diligence transferred to a third party, in the case of a bank issuing a LC, is accomplished by the small business owner assuming many of the activities of the bank with the use of a foreign exchange portal. These activities include acquiring a LOC, documentation review by the small business owner or owner’s agent, hedging foreign currency as necessary, determining satisfactory completion of stipulated portions of the foreign transaction and ultimately direct payment in the form of wire transfers or foreign drafts directly into the international bank account of the vendor. For small businesses, this process reduces the complexities of the LC, moves compliance from “strict” to “spirit”, and incorporates rapport and familiarization with transactional specifics into the equation to reduce the rejection percentages with the resulting costs associated with the LC. Use of the portal eliminates a unilateral third party who may be unfamiliar with the inherit intricacies associated with the foreign transaction. These intricacies may be rather difficult to place in written form required as part of the initial LC. The use of online capabilities and the information highway make this an increasingly appealing process moving the unilateral determinations inside the original business transaction and associating them directly with the small business owner. In the small business environment, it is distinctly possible that the success rate can be higher than that resulting from the use of traditional LC.

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