



INTERNATIONAL TRADE SERVICES OF BANKS IN THE EMERGING ENVIRONMENT

Parama Dharmawardene *FCIB, MBA (Sri.J)*

1. Introduction

Traditionally the commercial banks in Sri Lanka have been concentrating on international trade business to secure a major portion of their income and it continues to be a Key Business Area among most commercial banks operating in Sri Lanka, especially the indigenous banks. The traditional Receivable Trade Finance Instruments create significant value to both importers and exporters. To the importer they facilitate management of country risk, Exchange Control, provision of credit, outsourcing of document checking, comfort on performance / quality of goods. To the exporter they facilitate maintaining ownership of goods, bank guarantee of payments, greater predictability of payment timing, provision of credit and outsourcing debt collection.

Therefore importers and exporters were highly dependant on the banks to provide them the required services to enable them to continue their business operations and the banks, exploit these opportunities and create value to their import and export customers.

In 1977 with the liberalization of Exchange Controls importers were compelled to pay for all imports under documentary credits. This was a bonanza for the banks as all importers had to obtain the services of a commercial bank to have the documentary credits issued and to handle the documents received thereunder. However with the further liberalization, payments under Documents against Payment and Documents against Acceptance was also permitted thereby giving the importers greater flexibility to select a commercial bank of their choice. The exporters were not only permitted to use any method of payment from Advance Payment to Open Account they were even allowed to keep the export proceeds in an account overseas. The BOI approved companies, which were exempt from Exchange Control regulations were permitted to use a method of payment of their choice even for their imports. Permitting exporters and the BOI registered companies, which are exempt from Exchange Control these benefits and the granting of BOI status to a very large number of Apparel Exporters resulted in the deterioration of the profits made by banks in this key business area.

The domestic importers have been for sometime exerting pressure on the regulators to have a level playing field with the BOI companies for them to compete with foreign owned companies. However they have not had much success.. The only success came from the recent amendment by which the limit for advance payments for imports was raised from USD 7500 CIF Colombo to USD 10,000 CIF Colombo, which is hardly anything to shout about.



The commercial banks continue to benefit from the restrictions placed on the importers and exporters by the regulators and although it is good for the banks while it lasts the question that remains to be answered is for how long will this continue. This article attempts to focus on the some of the issues that impact this Key Business Area of the commercial banks in Sri Lanka and the challenges the future holds.

2. The Business strategy

The intense and increasing competition not only among commercial banks but also among importers and also exporters have made all of them to resort to strategies to be successful in this dynamic environment. Increase in turnover does not necessarily mean increase in profitability. Therefore cost reduction was introduced. However cost reduction efforts by importers and exporters also has an adverse impact on the profit margins of the commercial banks thereby pushing them to have a closer look at the services that they can provide and their pricing.

Today the management of risks has also emerged as an important factor in order to have a successful operation. The greater focus on risk management has not only forced the banks to incur additional costs but also refrain from engaging in transactions involving an undue risk even though the income from them is very attractive.




To add to this problem the business environment in the financial services industry continues to be highly competitive. This has forced the banks to cut down on their margins and retaining their customers has also become a major concern.

3. Customers

Loyalty of customers to a single bank appears to be a thing of the past. The emphasis on risk management has forced banks to limit their credit exposures to a single borrower, or a specific industry, etc. and has forced banks to request their larger customers to have at least another bank to provide the additional credit facilities required and share the risks. This has resulted in the customer playing one bank against another to get better rates for their transactions. Close monitoring of the customer's transactions and usage of credit limits have become extremely important to ensure that a bank is not losing the business to a competitor. Customer Relationship Management has become a buzz phrase today although it is not well understood by some.

3.1. Customer Relationship Management

Customer Relationship Management is a methodology, a way of creating and evolving an organization in the marketplace, and at the same time, in the mind of each individual customer. It must look at the whole process of what the organization is involved in, whether it is a product or service driven organization. It must involve every aspect of what the organization does – from



suppliers through to the end application, from the internal staff to the customer's customer. In its simplest form it recognizes that each customer is an individual and has a choice. It looks at ways to treat customers more as individuals and exercise their choice positively towards the organization. It also embraces many marketing and management methods, such as customer loyalty and marketing database management. There are three elements to consider when aligning the business towards a customer relationship format. The first is to do with retention. Developing the customer potential: turning that one-off infrequent casual customer into a higher spending and more frequent customer, is the second. The third element and the most controversial element is the de-selection of the customer. This is required for the organization to ensure that the limited resources they have are used to serve customers having greater potential.

3.2. Treat Customers Fairly (TCF)

TCF has been one of the newer concepts that have been introduced by the banks in Europe. In an era where customer loyalty is hard to come by this has become an extremely important attribute to retaining customers. Banks in Sri Lanka has had a history of exploiting customers and continue to do so whenever possible. This was the reason that increasing competition in the banking industry resulted in customers no longer being loyal to a single bank. First the corporate customers and thereafter the large business customers realised that they have not been receiving the best terms from their bank. This is now beginning to spread to the medium business segment as well. Banks have therefore been forced to offer finer rates than ever before even to the existing customers.

The practice adopted by banks in quoting exchange rates to their export customers, is a good example of this. The banks, when quoting an exchange rate, do not reveal the quantum of interest incorporated into the rate of exchange. Is this a fair practice? On the other hand whenever there is a delay in receiving the export proceeds the customers are charged overdue interest but why isn't the banks refunding any excess interest charged when the proceeds are received earlier than expected? Therefore the banks will need to have greater transparency in their dealings with their customers and be fair by them in order to ensure that customers do not lose faith in them especially when competitor banks approach the customer to canvas their business pointing out that the bank has been exploiting them.

4. Products and Processes

The traditional range of trade finance products and the processes used to deliver them continues to bring sufficient profits for the commercial banks thereby driving them to complacency that all is well. The emergence of B2B and B2C is a clear indication that the commercial banks need to acquire an additional set of products and new processes which will deliver greater value to the customers. Banks will need to have these new products and services which are well beyond those that were traditionally offered in order to retain their customers and stave off the competition that will come from the non-banking service providers who will use banks only for the purpose of making the payments



4.1. Outsourcing

Cost reduction will continue to be one of the key business strategies of not only banks but all business organizations. Towards achieving this objective banks all over the world have resorted to outsourcing with some degree of success. It is critical to determine what functions should be outsourced and what should be not. Many organizations has suffered as a result of not paying serious attention to this factor by focusing too much on cost reduction without looking at the larger picture. The core business competencies should never be sacrificed and outsourced even though the cost benefit in the short-term appears to be very attractive. It is more important to look at the dangers in the longer-term.

4.2. Insourcing

Insourcing has also become an attractive method of cost reduction and increasing revenue. This becomes possible when a process either requires a high investment in Information and Communication Technology or expert staff to handle the task. By increasing the volumes handled, the bank can utilize any spare capacity or gets the benefit of economies of scale and the resulting lower unit costs. This enables the bank to pass on a part of the savings to their business partner banks in the form of attractive pricing thereby making it a good business proposition to both parties.




4.3. Centralising

Banks have found that it is no longer required to handle the entire processing of certain types of transactions at each branch or service outlet, which are required to be close to the customer. The developments in Information and Communication Technology industry, has enabled banks to remotely handle some of the functions performed at each branch.

Therefore the centralization of the back-office functions is another strategy that is being used by banks to deploy a fewer number of specialized staff for a process and make better use of them rather than scatter them by deploying them at various branches across the country. This has proved to be a great benefit in the especially in the areas of documents checking and processing, the evaluation and preparation of credit proposals etc.

4.4. Private Label Documentary Credits

Many Banks abroad have been using fee-sharing schemes with their correspondent banks as an incentive for entrusting Documentary Credit business to them. However in the case of a majority of these Credits, the negotiations are done by banks other than the advising bank thereby loosing out on the opportunity to earn part of the negotiation commission. Therefore in certain countries like Hong Kong, where the laws and regulations require the negotiation under local Credits, "Private Label" Documentary Credits are used in order to ensure that the negotiation commission does not go to another bank. Under this scheme the local bank issues the Documentary



Credit as usual from Sri Lanka and sends the SWIFT MT700 to their Trade Services Subsidiary, which is operated and maintained by the Correspondent bank. The correspondent bank re-issues the Documentary Credit in the name of the subsidiary and advises it either direct to the beneficiary or through the beneficiary's bank. Documents drawn thereunder must be submitted to the Issuing Bank which is the Trade Services Limited Company for payment thereby ensuring that the negotiation / payment commission accrues to the Trade Services Subsidiary. The Correspondent Bank makes all the necessary arrangements on behalf of the local bank, which has very little additional work to perform. The Correspondent Bank earns a profit by sharing a monthly rebate with the local bank. Although this has become popular with the banks in some of the developed countries and a few countries in the Far East it is yet to become popular in Sri Lanka.

5. Technology and Human Resources

Use of cutting-edge technology in the handling of operations of banks has become absolutely essential if they are to effectively face up to the competition. The downside of technology is that it is costly and if sufficient volumes are not available it may not yield the desired results. To add to this continues upgrades are required to keep abreast with the developments in the Information and Communication Technology industry. However without extensive use of Information and Communication Technology no bank will be in a position to become a major player in the provision of International Trade Services in Sri Lanka. Some banks have looked at in-house developed trade services solutions. This is a waste of time and money. The volumes in Sri Lanka are such there is no way that a bank could justify the overhead cost involved in developing such software and maintaining it thereafter.

The alternative to reducing the cost of technology is to use human resources. However the people cost has also been steadily rising and it is becoming increasingly difficult to find the right quality staff in sufficient numbers. There is no more lifetime employment. Staff turnover has reached unprecedented levels and it is more than a challenge to retaining high quality staff. Bankers who migrate to countries such as the United Kingdom, Australia, Canada and the USA has been very high and to add to this there has been an exodus to Middle East countries is also high making it very difficult for banks in Sri Lanka to develop and retain staff for this key area of business.

There is no way that banks can ease off on staff training and development simply due to the fact that they may lose them in future. They should instead adopt a strategy to continue the training and development with greater intensity, even though it entails an additional cost. Banks should adopt policies to re-employ on their return to Sri Lanka, quality staff seeking foreign employment especially in the Middle-East countries, which makes it attractive for them to return to Sri Lanka after they have made sufficient earnings to be financially comfortable on their return. The expertise in this area has been on the decline and every effort should be made to adequately compensate the staff concerned in order to make it difficult for them to take the decision to leave



the organization. Technology should also be used to reduce the dependence on staff.

6. Profitability

Banks in Sri Lanka have been showing appreciable growth in profits in the recent years. This growth has been in Sri Lanka Rupee terms. However the return on the total assets employed of the domestic banks in Sri Lanka range from 1/2 % to 2 1/4 %. This in comparison to some of the blue chip companies, which are not in the financial industry, which record over six percent return on assets, is extremely low. It is reported Banks in Sri Lanka are among the banks having the highest interest spreads in the world, having an interest spread on their local currency transactions in the range of four to six percent per annum. The Central Bank of Sri Lanka has been continuously requesting the commercial banks to reduce the spread to acceptable levels. However due to the high cost of deposits and borrowings the same could not be said about the interest spread on foreign currencies. Although the interest bearing foreign currency assets and liabilities are very much smaller than those for the Sri Lanka Rupees there has been an increasing demand for foreign currency borrowings by the Sri Lankan exporters, which has adversely affected the profitability on the trade finance operations of banks. Since trade related business has traditionally contributed heavily towards the profits of banks in Sri Lanka, this trend does not augur well for the banks.

The growth in import and export volumes has not been significant except in the year 2004. The rising oil prices has also significantly affected the value of imports. The export and import values for the period 2001 to 2005 are given in tables 1 and 2 below.

You will observe that although the growth in terms of Sri Lanka Rupees is appreciable the growth in US Dollar terms is not the same. Since the foreign exchange profits earned by the banks are based on the foreign currency value and the increasing tendency for exporters to

Table 1. Exports from Sri Lanka

| Year | Value in LKR (‘000) | Growth % | Value in USD (‘000) | Growth % |
|------|------------------------|-------------|------------------------|-------------|
| 2001 | 430,372 | | 4,854 | |
| 2002 | 449,850 | 4.53 | 4,695 | (3.28) |
| 2003 | 495,426 | 10.13 | 5,141 | 9.50 |
| 2004 | 583,967 | 17.87 | 5,766 | 12.16 |
| 2005 | 638,276 | 9.3 | 6,345 | 10.04 |

Source: Central Bank Annual Report

borrow in foreign currencies instead of Sri Lanka Rupees, it has not been having a negative impact on the profitability of the commercial banks in Sri Lanka.

Considering the monopoly of the state banks to a major part of the imports made by the state owned enterprises, the private sector commercial banks indulge in intense competition for the remaining business thereby driving the margins down especially in the corporate and large



Table 2. Imports from Sri Lanka

| Year | Value in LKR (‘000) | Growth % | Value in USD (‘000) | Growth % |
|------|------------------------|-------------|------------------------|-------------|
| 2001 | 532,964 | | 6,011 | |
| 2002 | 584,491 | 9.67 | 6,181 | 1.50 |
| 2003 | 643,748 | 10.14 | 6,680 | 9.49 |
| 2004 | 811,138 | 26.00 | 8,009 | 19.90 |
| 2005 | 891,359 | 9.89 | 8,861 | 10.64 |

Source: Central Bank Annual Report

business segments. This has caused added problems to banks in improving their profitability.

7. Pricing Models

An innovation that has been developed by some of the banks especially in the United States of America is to have different pricing models, which are designed to make the income earned by the bank from each customer to be at least at the minimum level of return envisaged by the bank. The bank has a number of different pricing models for its customers. At the time when a new customer enters into a relationship with the bank, the bank obtains detailed information from the customer as to the products / services that the customer will be utilizing and the estimated volume and value of transactions that the bank will be entrusted with. The bank will then determine and apply the most appropriate model for that customer. Thereafter there will be regular monitoring of the relationship in order to verify the actual performance of the customer and as to determine whether the actuals match the estimates. If the bank finds after a reasonable period of time that the pricing model employed is not the appropriate one, the bank staff is given incentive payment to convince the customer to shift over to the appropriate model. This ensures the segmentation of customers and the application of different pricing models in order to ensure that the customer is profitable to the bank and that the customer enjoys terms and conditions appropriate for the volume of business entrusted and profits generated by that business. Thus there is no necessity for the bank to disengage customers for not providing an adequate return and the also helps the bank to avoid having to face the negative consequences of such an unpleasant decision. The bank will re-price the transactions in order to ensure that both the bank and the customer are kept satisfied.

8. Global Trend in International Trade

A clear pattern that has been emerging globally is that importers are relying more and more on regular suppliers to make their purchases making them business partners. This results in the building of trust amongst each other. Therefore they no longer consider it necessary to incur the



escalating bank charges by using Documentary Credits or Documentary Collections such as documents against payment or documents against acceptance. This change has seen over eighty percent of global trade being now carried out on Open Account terms. This has not only adversely impacted the earnings of commercial banks by the loss of the documentary business but they have lost control over the financing opportunities that had earlier. Customer retention has therefore become even a greater challenge.

8.1. China

One major factor that has gone against this trend is the China factor. China does most of its exports under Documentary Credits unless the buyers were agreeable to move a step further by making payments in advance. Since the export volumes from China has been snowballing to gigantic proportions the continuous trend to Open Account has been temporarily slowed down. The big question now is, for how long is China going to rely on Documentary Credit terms for their exports.

8.2. Documentary Credits

Asia and the Far-East continues to be the region having the highest quantum of Documentary Credit business and Sri Lanka has not been any different. Documentary Credits have been used to make payments for imports in to Sri Lanka also due to two other reasons. Firstly the country risk factor. Mainly arising from the instability due to the terrorist problem in the north and east of the country and its adverse impact on the country's economy, some of the overseas suppliers perceive Sri Lanka country risk as being high and therefore insist on Documentary Credits as the method of payment for any goods exported by them. The second reason is that, the regulators in Sri Lanka such as the Import and Export Control and the Exchange Control Departments making it mandatory for the use of Documentary Credits as the method of payment for certain types of goods imported into Sri Lanka. This practice has been adopted by the regulators, for the purpose of either monitoring the imports or as a deterrent for such imports.

9. Monitoring and Statistical function

In Sri Lanka the commercial banks have been forced to perform a monitoring function as well as a source to obtain various statistical information for the regulatory authorities. As far back as in 1977 with the liberalisation of Exchange Controls the need to obtain the support of banks due to the uncertainty of the repercussions of that policy decision may be justified. However the Central Bank of Sri Lanka has found it convenient to delegate more and more of these functions to the commercial banks claiming that they do not have staff in sufficient numbers in their department to carry out such duties. This has placed a very heavy burden on the commercial banks since they are required to deploy their staff to carry out these functions, most of which has to be done manually



9.1. The Regulatory Function

It is essential that timely and accurate information is available for the purpose of making sound decisions and for the monitoring of the transactions. Loading this responsibility on the commercial banks is a very autocratic decision of the Central Bank much to the dissatisfaction of the commercial banks. There is automation at the Exchange Control Department and at the Statistics Departments of the Central Bank, at the Customs Department as well as many other government institutions authorized to issue import licenses. These are all 'islands of automation'. It is not too difficult for those importers and exporters who are up to mischief to find loopholes in the system to continuously violate the regulations thereby gaining undue competitive advantage over the genuine importers and exporters. It is common knowledge that many importers remit funds through the black market and get their invoices for import of goods under invoiced so that the Customs duty and other levies are calculated on a lower value thereby defrauding the state of its revenue.

9.2. Automated Web-based Solution

The time is right for the setting up of a centralized web based system for all import and export transactions, which will facilitate the monitoring, regulating and statistical functions and ensure speedy and accurate information. The Exchange Control Department, The Import and Export Control Department, the Customs Department the Inland Revenue Department, the other state organizations involved in the process and the commercial banks should all be participants and have access to input data to this system with facilities to upload data files from the computer systems of these institutions without any manual effort. Tracking each transaction at its different stages is absolutely essential. For example, in the case of an export the quantum of goods shipped the value of documents submitted and the receipt of proceeds and the dates of each of these events should all be tracked. Similarly in the case of imports the value of documents received, the value of the payment remitted the quantum of goods received and their dates should all be available. The savings to all parties concerned will be immense and it would help to bring to book the fraudsters and clean up the system It should not be too difficult to find an international aid agency to donate funds for this project and it would make business sense even for the commercial banks to chip in with some contributions towards the cost of the project.

The system should be designed so that there will be no duplication of data entry at any of the participating organizations as well as the importers and exporters. Facilities should also be provided to those importers / exporters who do not have automated systems, in order for them to carry on their business without too much difficulty and motivate them to move into some degree of automation thereby reducing their costs. The level of Information and Communication Technology expertise available in Sri Lanka is more than sufficient to handle this project locally but it is absolutely essential that representatives from all the parties concerned are consulted and all representations made are noted and the feedback received is also taken into account before deciding on the final system design, without the regulators making another autocratic decision.






Another aspect that is in urgent need of attention is for the codification and updating of various regulations governing imports and exports. The Exchange Control manual is outdated. Even the Exchange Control Department has been struggling to put out an index of all operating instructions to 'authorised dealers', which are operative so that banks will apply them uniformly. Some of the obsolete practices should also be discontinued. For example when the only method permitted for making payments for imports, as was the case in 1977, there was a penalty charged to the importers who received shipment of goods after the expiry of the Documentary Credit. Today when even Documents against Payment or Documents against Acceptance is permitted as methods of payment, importers are required to pay a penalty for Documentary Credit transactions where the Credit has expired at the time of receipt of documents. Another example is that, the prior approval of the Exchange Control Department is required if goods in commercial quantities are imported to Sri Lanka free of charge. However there are many instances where importers who have obtained the release of documents on Documents against Acceptance basis do not make payment, effectively making it free of payment, and no action is taken against such importers.

10. Uniform Customs and Practice for Documentary Credits

The 1983 revision of the Uniform Customs and Practice for Documentary Credits (UCP500), which came into force with effect from 01 January 1994 and is currently being used is in the process of being revised. The committee appointed to draft the new revision of the UCP has been meeting regularly for the last few years and the final draft has been circulated to the national committees of the International Chamber of Commerce (ICC), for their comments. At the outset, far reaching changes were envisaged in order to cater for the rapidly changing environment. However there was opposition from certain national committees to such changes and the final draft, although addresses some of the problems faced under the UCP500, appears to be more of a more logical arrangement of the existing clauses with some improvements in the wording for clarity and a re-classification. The application of the new UCP rules to standby letters of credit was an issue, which was hotly contested. However since the majority for removing the application was very small it was decided to continue without a change. Thus, a good opportunity to obtain greater recognition for ICC's International Standby Practices ISP98 by getting the users to make it applicable to all their Standby Letters of Credit, was lost.

However, there is one significant change that is extremely important to bankers. The ICC drafting committee has given recognition to issuing of Documentary Credits by parties other than banks. This has been necessitated by the fact that there are corporates, who are bigger and much stronger than banks and whose creditworthiness is acceptable to the beneficiaries. This will definitely have an adverse impact on the business of commercial banks, similar to the loss of income suffered by the banks when the corporates started having their own treasuries to maximize their profits. The new revision, the UCP600 is expected to come into force with effect from 01st July 2007.

With the introduction of the new UCP revision it will become necessary to examine the



provisions in the other related publications such as the International Standard Banking Practice - ISBP645, the e-UCP version 1 which is the supplement to UCP500 for Electronic Presentations, and also the Uniform Rules for Bank-to-Bank Reimbursement under Documentary Credits - URR525, for compatibility. It may not be possible to complete this task prior to the date with effect from which the UCP600 will come into force. This may create problems and lead to disputes among the practitioners. The ICC's Commission on Banking Techniques and Practice may need to have more regular meetings to settle such disputes by delivering opinions until the necessary revisions are carried out for those publications as well.

11. SWIFTNet Trade Services Utility

Supply chain integration and risk management have been at odds for too long. The Trade Services Utility could provide a data-matching solution that reconciles the two needs.

Paper-based documentation chains still prevail in the majority of documentary trade business - namely inter-corporate trade deals requiring some form of guaranteed payment. Although financial settlement terms have been standardized over the years, the underlying documentation chain remains in multiple data sets and from differing data sources. For this reason, errors can occur that prevent goods or funds being released to allow the timely completion of a transaction. Although it seems counter-intuitive, the very documentation intended to reduce risk can therefore become a source of 'documentation risk'.

A narrowly defined dataset - especially one that reduces the amount of data exchanged - would therefore greatly facilitate supply chain integration, while also allowing banks to support risk mitigation for transactions settled via open account, or on 'semi-open account' basis. This would need to address highly diverse and specialized commercial requirements, which have hindered past attempts to develop internationally accepted standards of trade documentation. A universal standard and a common infrastructure for closer, undisputed matching of trade data is still a priority. But given the difficulty of establishing these across different markets and industries, any solution must take a simplified, minimalistic approach - covering the majority of trade deals and leaving aside complicated and highly specialized variations.

A Common Data Platform is the goal of the Trade Services Utility (TSU) currently under development by SWIFT and is being tested together with a number of pilot banks. The TSU provides a common standard for a simplified trade data set and a messaging service for matching this data for banks. This will bring a high degree of efficiency to the exchange of trade data, both between corporates and banks as well as between banks. There is a parallel with the achievements that web-enablement by individual banks has already provided to 'traditional' documentary credits, such as LCs and their underlying datasets. However, in contrast to individual bank solutions, TSU offers a multi-bank, multi-country data standard and matching service.

Cost reduction and risk mitigation are achieved both at the corporate and at the bank level via highly automated data-matching between related source data. This in turn opens the way for






new ranges of financial services. But to avoid falling prey to project-creep, or interfering with competitive areas of banks, TSU is limited to the minimum level of common functionality needed and restricted to the data exchange between banks. Indeed, the aim is not to impose a rigid infrastructure on all trade participants along the complete trade chain - it is simply to support the exchange and matching of corporate supply chain information between banks, thus enabling them to add to the various financing and settlement tools at their discretion. This should free up the physical supply chain by reducing its dependence on the paper-based documentary elements of the financial supply chain.

Today over 80 per cent of world trade is based on open account, with related data-matching done predominantly at corporate level. From a corporate perspective, TSU is highly complementary to streamlining corporate data processing, service outsourcing and hubbing operations. But the broader demands of creating technical interfaces to support such integration are complex and time-consuming. From a bank's perspective, there is the prospect of servicing corporates on their data-matching needs even in open account transactions. This enlarges the field of financing and risk mitigation possibilities, while reducing the related processing cost to both the corporate and the bank.

Trade financiers could consider there to be a risk of biting further into the market for traditional paper-based documentary credits. But there is also the chance to regain lost territory on trade risk services via customer-friendly e-solutions, and combining these with tailor-made structured financing and risk solutions. This would require integration of TSU services into the overall trade product concepts of a bank, and includes costly adjustments to related technical internal and external tools. From a regulatory perspective, the prospect of using the TSU matching engine for more structured transactions such as Lite Documentary Credits or Lite collections, as we would hope to, may introduce the need for a review of the UCP and eUCP inter-bank standards set by the International Chamber of Commerce.

Achieving tangible cost reduction and efficiency gains for corporate clients and banks are the number one criteria. This extends to the enhancement of other trade services that rely on similar tools, or on trade data exchange in correspondent banking. However, this goal will require TSU to be embraced by main trade counterparties relatively quickly - an aim supported by the fact that the TSU will be introduced into the market by SWIFT, bringing with it global reach and a proven track-record in establishing bank-wide industry standards. Furthermore, implementation should be supported by major global trade bank members of SWIFT, such as those represented in Trade Services Advisory Group (TSAG) and related committees. While TSU takes its first steps into the market with the simplified open-account approach, it is also intended for further targets such as the introduction of data matching for "Lite Documentary Credits" and "Lite Collections", as well as enabling related settlement standards. This would bring even more business through the TSU process - in turn significantly reducing bank's operating costs. The ultimate success factor may therefore actually be to change significantly the way in which most traditional Documentary Credit business is settled. That is not to negate the long-term demand for traditional, paper-based Documentary Credit solutions. But, if all works out well, much of this business could in the long term migrate towards a TSU process.



Migration to open account has left banks often involved in corporate transactions only at the settlement end of the trade chain. In order to re-intermediate themselves banks need to provide more value by extending their existing corporate trade services to support broader supply chain integration. Following the successful completion of a prototype exercise and supported by market validation, the SWIFT Board approved going ahead with the development of the SWIFTNet Trade Services Utility (TSU) as a commercial offering. The TSU, a collaborative centralised matching utility, will allow banks potentially not only to increase revenues but also to share costs when engaging in the provision of services such as:

- Finance and risk mitigation
- Management information
- Insourcing of payables and receivables
- Insourcing of trade data checking

Banks will build individually on the core functionality of the TSU to offer competitive services that will be complementary to their existing offerings to their corporate customers. The first release of the TSU is designed to support bank solutions based on purchase order financing.

Upon completion of the pilot phase a full commercial launch of the TSU service is anticipated for late 2006.




The key concepts of the TSU are:

- central matching and workflow engine
- accessed only by financial institutions
- supporting new/enhanced services to corporates comprising messaging services, standards and a business application

February 2006 marked the beginning of the SWIFTNet Trade Services Utility (TSU) pilot phase. From December 2005 onwards the SWIFT team and the eighteen pilot banks were busy putting the final pieces in place. Workshops and training sessions provided information and training for the pilot banks while generating valuable feedback for the SWIFT team and essential interaction all round.

The TSU principles agreed are as follows:

- The TSU does not make business decisions
- Bank-to-corporate and corporate-to-corporate obligations are outside the scope of the TSU
- The TSU works with data elements/sets, not with trade documents
- A TSU data set does not represent a corporate contract per se, nor does it establish one, and any service offerings provided by a bank to its corporate clients are totally independent from the TSU itself.



These principles have enabled SWIFT to differentiate between the collaborative space in which it operates and the competitive space in which the banks operate.

The **TSU Rules Working Group**, advises SWIFT on the regulatory environment in which the TSU will operate. It is helping SWIFT to define the TSU rules framework, ensuring that TSU-bank based services requiring inter-bank co-operation can operate smoothly. The Roles and Responsibilities section of the TSU Service Description will be the first output. The TSU Service Description is being finalised.

The TSU Business Working Group *has been given a two-fold objective:*

- To achieve a common understanding of the potential business benefits to be derived from the TSU, and
- To assist in the development of the value proposition that will be used to support market positioning.




The business opportunity for the banks revolves around intermediation into open account. Data matching at trigger points across the supply chain increases users' confidence. Data visibility facilitates improved management of risk and financing. It also creates opportunities for banks to offer value-added information services, for example to help corporate treasurers optimise liquidity, and it supports process insourcing.

As the preparatory sessions wound up, the eighteen banks moved confidently into the pilot phase. Over the next few months they will share their experience with the SWIFT community as they prepare to go live. **The eighteen pilot banks for the SWIFTNet Trade Services Utility are:** ABN AMRO, Banca Intesa, Banco do Brasil, Bank of Tokyo-Mitsubishi UFJ, BNP Paribas, Calyon, Citibank, Deutsche Bank, First Rand Bank, HSBC, JPMorganChase, KBC, Mizuho, RBS, Société Générale, Standard Bank of South Africa, Standard Chartered Bank, The Bank of New York

Since the commercial banks in Sri Lanka have taken the decision to set up a SWIFT Service Bureau they will have take steps to increase the message traffic exponentially to make the project viable. Therefore the banks will have to start using the utilities such as SWIFTNet FileAct and SWIFTNet Browse to become familiar with them for them to move on the SWIFTNet TSU in the future. These are areas that the banks in Sri Lanka have so far feared to tread. Banks will have to make immediate arrangements to obtain the necessary expertise by training their staff.

12. Conclusion

The control that banks in Sri Lanka had over their customers has been fast disappearing and the new developments are also bound to reach Sri Lanka in the not too distant future. Therefore the banks will have to work together to ensure that they take the lead to provide these new supply chain solutions in order to create value to their customers. Failure to do so may mean that other industries such as the logistics firms will enter the fray and take the lead, which will result in



a loss of a business opportunity and revenue and greatly reduces the role played by banks in international trade.

Risk Management has become one of the most important aspects of banking business today. If the banks do not take the lead in the newer developments, the solutions provided by the others such as the logistics firms may not meet the risk management requirements of the banks and limit the ability of banks to get sufficiently involved in the customers' affairs to make the maximum use of the arising business opportunities and thereby lose customer loyalty as well, with drastic consequences.

The terrorist problem in the north has always been a very heavy strain on Sri Lanka's economy retarding the progress of the country. This problem has continued for decades and a solution has not been in sight. We need to look at two scenarios that are possible for this problem. The first is for the continuation of it, which will not see much improvement in the business environment. However, if we ever have the fortune of finding a solution to this problem, the business opportunities will spring up at such speed that there will not be sufficient time to work on new infrastructure development projects.

The commercial banks in Sri Lanka having taken a very bold decision to set up a SWIFT Service Bureau will find that it makes business sense to invest in the development of an infrastructure such as an automated Trade Services Utility so that they not only continue to keep abreast with the latest developments in the banking industry in the developed world but also be in a position to offer cost effective solutions to their customers. They can ensure that they will reap all the benefits by being the hub of the operation rather than being a spoke for a hub set up by non-bank institutions.

Insourcing is an important strategy available to banks in Sri Lanka. India has been successful in getting banks in the US and Europe to locate their back office operations in India thereby earning foreign exchange income as well as creating employment opportunities for their people. Now that HSBC has taken the lead in locating their back office for payments in Colombo it is opportune to explore the possibility of providing back office services for trade finance operations in Colombo for some of the big US or European banks

Finally, the time has come for the commercial banks to initiate a project for having a fully automated web-based system with a secure communication network to host the data for all import and export transactions. This will relieve the banks from the major burden of doing monitoring and statistical reporting and all other manual work they perform on behalf of the regulatory authorities and have an appreciable reduction in the costs being incurred by them. The regulatory authorities will also be better equipped to have a sound monitoring system with information for speedy action and also to ensure that there is no violations of regulations and no defrauding of state revenue.

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