Educational report
Observations on the Evolution of Trade Finance and
Introduction to the Bank Payment Obligation
Foreword

At the dawn of 2013, the world continues to wrestle with several serious global challenges, including ongoing impact of the financial crisis which began in 2007, more recent sovereign risk issues and concerns about the future of the Euro and the European Union, challenges in the US and some signs of slowdown in other key economies. In addition, there continue to be ongoing serious issues in the banking sector.

Amid these difficult realities, political and business leaders continue to look to robust trade and investment flows to sustain the global economic system and to serve as the engine of recovery from the most serious of the crises we face together. With an expected growth of 8% per year until 2020, trade has powered the growth of several economies that can now claim positions of leadership in the international community; trade remains a cornerstone of many efforts related to international development, poverty reduction and economic growth in the developing world.

This growth has driven an evolution in and extension of global supply chains, and a demonstrable change in sourcing patterns, both pre- and post-crisis. The industry now speaks of physical, financial and information supply chains, and supply chain “ecosystems”. These ecosystems, involve an increasing number of small and medium-sized enterprises – many in emerging markets – with varying commercial and financial profiles that have an impact on the overall nature, robustness and sustainability of those supply chains.

One of the enduring lessons learnt at the peak of the global economic crisis, was the central – even indispensable – role of trade finance in enabling the successful conduct of cross-border commerce. At the peak of the inter-bank liquidity crisis, trade finance (like other forms of credit) became scarce and expensive, with pricing at the short-term end of the business reaching levels four to five hundred percent of normal. Difficulties in securing pre-export finance resulted in a striking drop of 40% of trade flows from Asia to Europe and the Americas, with the cost of ocean transport dropping by 90%.

While the situation has stabilized significantly since that time – even normalized in many respects – the link between trade flows and trade finance (including supply chain and working capital finance) has been brought sharply into focus: a reality well-known among practitioners is now well appreciated among senior business and political leaders and key players in the family of international institutions engaged in global commerce.

A second lesson – and a central reality of the current environment – relates to the imperative for effective, but equitable regulation of banking activity. Trade finance has suffered a partially self-inflicted injustice in the context of regulatory developments around banking, but senior industry leaders have now fully engaged to help shape the dialogue – and the business realities – related to the regulation of international banking and trade finance.
This Paper seeks to explore selected characteristics of the trade and supply chain finance market today, doing so with a view to illustrating the evolution of the trade finance value proposition, the evolution of global trade, the needs of corporate clients in trade-related liquidity and risk mitigation, and the emerging solutions offered by bankers and other providers of trade finance.

Yours sincerely,

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BACKGROUND

The business of trade finance is well-established, with a solid set of traditional instruments that have earned global trust and proven their effectiveness over a period of several hundred years, perhaps longer. While the demise of the documentary letter of credit has been predicted for the last two decades or more, the letter of credit (L/C) has proven to be very resilient, still supporting approximately ten percent of global merchandise trade flows. There have been a variety of attempts since the late nineteen nineties, to devise technology-based solutions, even to ‘dematerialize’ the paper flow linked to the use of L/C’s, the promise of technology has been slow to be fulfilled in commercial terms though recent developments in this area merit attention.

There has been a clearly observable shift, particularly pre-crisis, but once again discernible in current market dynamics, to the conduct of trade on open account terms. This shift was initially driven by large retailers seeking to reduce transaction costs and to improve competitiveness. The shift to open account as the preferred mode of settlement has become pervasive, even in markets that were previously considered relatively risky and therefore perfectly suited to the documentary credit.

As the primary providers of trade finance solutions, trade banks globally responded to the shift to open account by developing a suite of solutions under the label of “supply chain finance”. The industry initially debated whether supply chain finance represented an evolution in the trade finance value proposition, or nothing more than a marketing-based repackaging of well-known banking products.

In the end, the process of attempting to develop a value proposition in response to shifts in client expectations, has driven an evolution in the nature of trade finance, and has motivated trade bankers to take a far more holistic view of trade, in the context of global supply chains and the commercial ecosystems which enable those supply chains. It is in this area that trade banks anticipate significant opportunity for growth in the coming years.

Corporate executives from leading organisations across the globe have indicated an appreciation for the robustness and flexibility of traditional trade finance mechanisms such as the L/C, while at the same time, expressing a desire for greater efficiency, speed and flexibility, reduced complexity and, not surprisingly, reduced cost. SME’s in particular continue to decry the lack of accessible and affordable financing (including trade finance), and are therefore receptive to solutions based on supply chain finance, that facilitate access through the borrowing capability of their larger trading partners.

There is evidence of a growing expectation among importers and exporters, that service providers should leverage technology, and should work to devise 21st century models and processes to facilitate international commerce, whether in the physical supply chain, the financial supply chain or the information supply chain. A combination of circumstances and shifting client expectations have motivated trade financiers and trade bankers – jointly with their key partners – to seek such new models and propositions, and the recent (and ongoing) global crisis has reminded trade bankers to draw from the successes and lessons of traditional trade finance.
STATE OF THE TRADE FINANCE MARKET

The Four Elements of Trade Finance

Trade Finance, at its most simple or its most complex, involves some combination of four elements:

- Facilitation of secure and timely payment across borders
- Provision of financing to parties in a supply chain or trade transaction
- Effective mitigation of risk
- Facilitation of information flow

The nature of a client’s requirements, driven by the trading relationship, the market(s) involved, and the needs of the client company itself, will determine the relative priority of one element over the others, and the exact mix of solution elements in a particular transaction, or in the context of a given trading relationship.

Four Elements of Trade Finance

Source: Practical Insights: Documentary Letters of Credit
OPUS Advisory Services International Inc.

In the end, widely accepted industry estimates suggest that 80-90% of merchandise trade flows globally, are supported by some form of trade finance, including supply chain finance and support linked to open account transactions.

The WTO on Trade Finance

Trade finance is at the low-risk, high collateral end of the credit spectrum but this has not insulated it from the crunch (US Department of Commerce 2008). Some 80% to 90% of world trade relies on trade finance (trade credit and insurance/guarantees), mostly of a short-term nature. The potential damage to the real economy of shrinking trade finance is enormous (IMF 2003). International supply chain arrangements have globalised trade finance along with production. Sophisticated supply-chain financing operations — including for small- and medium-size companies — have become crucial to trade.

**Observations on the Evolution of Trade Finance and Introduction to the BPO**

**The Trade Finance Market**

Trade finance in its traditional form is a highly specialised element of the value proposition provided primarily by banks, with some smaller, non-bank providers also active in the market, most commonly servicing the small and medium-sized enterprises that are typically under-served by banks across the globe. The business of financing international commerce is highly concentrated, with the top global banks accounting for the vast majority of trade finance activity.

Traditional trade finance has been in use for at least several hundred years if not longer, and one of the most familiar instruments of trade finance, the Documentary Letter of Credit, traces its origins to the very early days of this form of financing. The Letter of Credit (L/C) is acknowledged as a flexible and highly effective instrument of trade finance, however it is in some respects complex and cumbersome, highly process-intensive, prone to error and therefore unpopular among importers and exporters in most markets across the world.

The complexity of use of the L/C, together with the process intensive nature of its transactions and the (perceived) high cost of this instrument, have been at the root of a decades-long shift away from the L/C toward the conduct of trade on Open Account terms, where the importer and exporter simply agree to settlement via credit to the account of the exporter, largely eliminating the need for bank intervention in trade transactions.

![Import Volumes and Expected Bank Revenue Pools](image)

*Source: BCG, June 2012*

The growth rates going forward through 2020 are clearly evident in both traditional documentary trade and in trade on open account terms, with the latter expanding at much faster rates and resulting in new revenue opportunities, as illustrated in the above graphic.
While industry metrics are difficult to obtain, the illustration below provides an estimate of the breakdown of various types of trade finance, with “Bank Trade Finance” (including letters of credit) accounting for up to 40% of trade finance activity in 2008, and Open Account terms applied in up to 45% of trade transactions in that period, which it bears noting, is in the midst of the global crisis.

**Trade Finance Market Size**

![Trade Finance Arrangements Diagram](image)


It is widely accepted that somewhere in the range of 80-90% of global trade flows are facilitated or enabled through some form of trade finance, and it has been clear over the last thirty years, that the use of L/C’s has been trending downward as a proportion of total trade finance.

**Evolution of Trade Finance**

That said, the L/C remains disproportionately important to trade in certain markets, notably the Middle East, and demonstrates robustness in times of crisis, as importers and exporters return to this mechanism based on its adaptability and its highly effective risk mitigation capabilities.

**Traditional Trade Finance**

The average value of a Letter of Credit in 2011 was USD 603,000

From 2004-2009, the total value of Letters of Credit on SWIFT was of the order of USD1.5 trillion per annum. The indicative market share of world merchandise trade for Letters of Credit on SWIFT (MT700) is 9.3%. Documentary Collections account for about 1.4%.

Source: SWIFT, as Quoted in ICC: Rethinking Trade & Finance 2012

The letter of credit remains a significant instrument in enabling global commerce, however, trade flows were clearly shifting to Open Account over a period of several years prior to the global financial and economic crisis, driven largely by the demands of
large retailers, and taken up more broadly thereafter, by companies of all sizes engaged in import/export activity.

**Letter of Credit Volumes (SWIFT MT 700 Traffic)**

![Letter of Credit Volumes Chart]

*Source: SWIFT, 2012*

**Emergence of Supply Chain Finance**

The shift to Open Account terms represented a clear challenge to trade finance banks, rendering them largely irrelevant except as facilitators of payment, and presenting a real threat to their activities as key enablers of cross-border commerce.

While there had been numerous attempts since the late 1990’s, to create technology-based trade settlement and finance platforms, such efforts evidenced limited take-up, and even the most successful of these initiatives did little to raise substantial concern in trade banking circles.

Just prior to the global financial crisis, trade bankers had been working to devise a new value proposition to “re-intermediate” themselves as key providers of trade finance solutions, aiming specifically to respond to the needs of companies trading on Open Account terms. These propositions were most commonly envisioned in the context of international and global supply chains – and were collectively termed “Supply Chain Finance”.

The global crisis, erupting in late 2007, initially derailed efforts to innovate around trade and supply chain finance, as the inter-bank lending crisis caused pre-shipment and trade finance more generally to evaporate. Over the medium term however, the unprecedented profile accorded to trade finance by senior political and business leaders across the globe, has positioned the industry for greater innovation and has put into
sharp focus, the invaluable contribution of trade and supply chain finance as an enabler of global commerce and of economic growth and prosperity.

*The Impact of Regulation*

Robust trade was quickly positioned as one of the primary facilitators of global economic recovery, and the core role of trade finance was widely and acknowledged, raising the profile of the industry to unprecedented levels, and motivating investment and innovation at rates previously unseen in the industry.

As trade remained in focus, the global banking sector attracted far less favourable attention for a variety of legitimate reasons. Political pressure to subject the industry to more stringent regulation – including tougher capital adequacy requirements – gained momentum, and trade finance, through its own lack of engagement in the consultation processes, suffered adverse consequences despite its widely acknowledged low risk profile.

Trade continues to be seen as one of the key contributors to global stability and eventual economic recovery, and trade finance – provided by banks, export credit agencies and increasingly active international financial institutions – continues to benefit from high profile and visibility. The regulatory environment has motivated the industry to gather and disseminate portfolio-level data to prove, objectively, that the business of trade finance exhibits highly effective risk mitigation and very low levels of default and loan loss, to the long-term benefit of the industry and to the benefit of global trade.

The Asian Development Bank led an industry initiative to collect portfolio-level data, and to undertake the analysis necessary to demonstrate in objective terms, the risk profile of the trade finance business, down to the product level. This initiative has been a critical first step in providing a view of the trade banking business to regulators, political leaders and to senior (non-trade) banking executives, based on data contributed initially by eighteen leading trade banks from around the world.
Observations on the Evolution of Trade Finance and Introduction to the BPO

Trade Finance Default Data

<table>
<thead>
<tr>
<th>Product</th>
<th>Transactions</th>
<th>$ in 000s</th>
<th>Default %</th>
<th>Loss %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans for Export – Bank Risk (2008-2010)</td>
<td>955,201</td>
<td>355,073,525</td>
<td>0.1733</td>
<td>0.0127</td>
</tr>
<tr>
<td>Loans for Export – Corp Risk (2008-2010)</td>
<td>1,009,922</td>
<td>234,398,914</td>
<td>0.2918</td>
<td>0.0167</td>
</tr>
<tr>
<td>Loans for Import – Corp Risk (2008-2010)</td>
<td>655,199</td>
<td>389,796,641</td>
<td>0.0597</td>
<td>0.0697</td>
</tr>
<tr>
<td>Import L/Cs (2007-2010)</td>
<td>1,438,291</td>
<td>727,012,390</td>
<td>0.0673</td>
<td>0.0061</td>
</tr>
<tr>
<td>Export Confirmed L/Cs (2008-2010)</td>
<td>389,129</td>
<td>195,664,331</td>
<td>0.0907</td>
<td>0.0349</td>
</tr>
<tr>
<td>Performance Guarantees/Standby L/Cs (2009-2010)</td>
<td>396,059</td>
<td>347,828,425</td>
<td>0.0135</td>
<td>0.0007</td>
</tr>
</tbody>
</table>

Source: ICC: Trade Finance Global Risks, 2011

Default rates in the initial portfolio data are strikingly low, and even of those transactions in default status, an average of 60% of funds are recovered. When default rates such as those above are viewed in the context of the complex, cross-border nature of trade banking, and contrasted against loss rates in mortgage or credit card portfolios, the attractive profile of the trade business becomes clearer and even more compelling.

While trade finance pricing has normalized from its crisis-driven peak of 500% of normal levels, regulatory demands applied to conventional banking, and extended by default to the business of trade finance, risk adversely impacting both the availability and cost of trade and supply chain finance, at a time when the international economic system can ill-afford such adverse impact.

Senior leaders in trade finance continue to engage with key stakeholders to redress the situation related to capital adequacy requirements. Though there has been some positive progress, challenges remain, and the industry continues efforts to advocate for equitable treatment, while working to gather additional data in support of requests for revised treatment of trade banking and trade finance.

Political and business leaders continue to point to robust trade flows as a means of recovery and sustained prosperity, however, inequitable regulatory treatment of the industry poses significant challenge to the assured availability of fairly-priced trade finance, creating the risk that added costs incurred by the banks will be passed on to importers and exporters, with direct implications for the conduct of international trade.
According to estimates from Standard Chartered Bank, the new proposals [Basel III] will lead to an increase in trade finance pricing of between 15% and 37%. This in turn, according to the bank, could lead to a reduction in trade finance volumes of 6%, which would also mean a reduction in global trade by $270bn per annum, and a 0.5% reduction in global gross domestic product.


**Financing Global Supply Chains**

As the industry continues to wrestle with the issue of regulation, and seeks to secure fair treatment of its asset class from stakeholders at the supra-national and national levels, trade finance is engaging in an unprecedented effort around innovation and the redefinition of its value proposition for importers and exporters, largely along the path initiated prior to the advent of the global crisis: the development of mechanisms and solutions suited to the needs of global (increasingly complex and often fragmented) supply chains. These mechanisms combine long-established bank products in a suite of solutions aimed at importers, exporters and other participants in global supply chains. Such solutions increasingly aim to address the varying requirements of business of various sizes and commercial and financial profile.

**Supply Chain Finance**

SCF programs allow buyers to extend payment terms from 60 to 120 days while providing suppliers access to better financing rates (e.g., 120 days at 100 bps instead of 60 days at 500 bps). According to industry sources, SCF could unlock $100 billion to $500 billion of liquidity by accelerating the cash conversion cycle for suppliers and extending days payables outstanding for buyers.


Whether such efforts were initially no more than a repackaging of existing products, or whether they represented true innovation, is almost irrelevant at this stage: the business of trade finance has evolved a more holistic view of its value proposition, and has positioned its offering in terms of commercial solutions, in the context of broad transaction banking activities, as opposed to in the traditional, silo-based product view, long favoured by the banks. Additionally, the critical role and ongoing importance of export credit agencies and international financial institutions has been undeniably reaffirmed, to the long-term benefit of global commerce.

Where certain banks and trade finance providers focus on a subset of activities, such as buyer-centric programs, others (typically global banks and international institutions) envision a wider suite of solutions around supply chain finance, seeking to provide value across a transaction lifecycle, and potentially to several parties in the supply chain ecosystem.
Leading financial institutions now position trade and supply chain finance within broadly mandated transaction banking units, with several linking these activities to the provision of liquidity and working capital solutions – both cross-border and domestic in scope.

The evolution of the trade and supply chain value proposition, and the high profile which continues to accompany this business today, combine to create a set of circumstances which enable senior trade financiers to truly champion their business, and to secure organisational support for further investment and innovation.

**Working Capital and Liquidity**

Supply chain finance propositions positioned in terms of working capital and liquidity, have allowed banks to decouple the traditional tension between importers and exporters as relates to settlement and financing by accelerating the Cash Conversion Cycle (CCC) – where the exporter seeks to accelerate payment (reduce Days Sales Outstanding - DSO) and the importer seeks to delay settlement (extend Days Payables Outstanding-DPO).

Trade banks have positioned Supply Chain Finance as one means by which the objectives of both exporters and importers can be attained simultaneously.

**Source:** International Finance Corporation (IFC)
Short Term Trade Finance, 2011
Trade and Supply Chain Finance: Current State

The business of trade finance is in an environment of innovation and potential, at the same time as it faces unprecedented (and in many ways unintended) regulatory pressure arising from the impact of the global crisis, and from an ill-advised historical approach to engagement with regulatory authorities.

Trade financiers have a unique opportunity to champion their industry and to shape its future under a complex set of commercial and political circumstances, while facing continuing demand from customers of all sizes to innovate, and to shift decisively from a product orientation to a solution orientation.

Current realities provide a unique opportunity for transformational evolution in the proposition, processes and value of trade and supply chain finance, and those who perceive this opportunity, and can shift from incremental refinements of long-established processes to truly innovate in support of global commerce, will benefit from this temporary set of circumstances unlikely to be seen again in the foreseeable future.

It is in this context that leading providers of trade finance across the globe have partnered with SWIFT and the International Chamber of Commerce (ICC), to conceive, design and launch the Bank Payment Obligation or BPO.

The BPO is an irrevocable undertaking given by one bank to another bank that payment will be made on a specified date after a successful electronic matching of data according to an industry-wide set of rules, the ICC Unified Rules for Bank Payment Obligation. In a BPO, sellers send shipping documents directly to the buyers, accelerating the settlement process.
This new Supply Chain Finance instrument has been developed to provide bank-assisted trade risk mitigation services that offer the security of documentary credits and the payment flexibility required by global supply chains.

The BPO addresses the key four elements of Trade Finance, identified earlier:

1. Payment

   The BPO is a payment assurance. On one hand, sellers get the assurance to be paid on time as per the payment terms, while buyers can control the payment execution and optimize their banking credit lines. Compared to documentary instruments, BPO is expected to improve the cash conversion cycle for exporters.

2. Financing

   The BPO is positioned, and has been accepted by banks, as possible collateral for financing. It has been recommended that the BPO be granted similar accounting and capital treatment as an L/C. Sellers can benefit from pre/post-shipment financing from their own bank based on approved purchase order or approved invoice under a BPO, while buyers can negotiate extended payment terms with their respective bankers under a BPO. The use of a Bank Payment Obligation allows for the provision of financing to either the importer or the exporter.

3. Information

   The Electronic information flow related to a BPO transaction is based on ISO 20022 standards:
For exporters, the available data will help to improve liquidity forecasts and discrepancy/amendment management. The ISO 20022 structure will facilitate the integration with e-invoice services.

4. Risk Mitigation

The BPO transfers risk from the buyer to one or several banks. Sellers can mitigate the financial, commercial and some transport and economic risks as described in the table below.

Buyers can pay suppliers on time to avoid a physical supply disruption, reduce inventory outages or eliminate demurrage costs. More importantly, buyers who have deployed a high level of agility in their logistics process will have the flexibility to meet market demand.
Observations on the Evolution of Trade Finance and Introduction to the BPO

<table>
<thead>
<tr>
<th>Risk</th>
<th>Risk description and relative protection of each trade finance instrument from the point of view of the seller</th>
<th>Open Account</th>
<th>SBLC/guaranteed</th>
<th>Unconfirmed L/C</th>
<th>Confirmed L/C</th>
<th>BPO</th>
<th>Comments and rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial</td>
<td>Weak credit rating or financial solvability of the buyer</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Substitute by bank’s credit worthiness</td>
</tr>
<tr>
<td></td>
<td>Temporary liquidity shortage of the seller (offer shorter terms to the seller)</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Finance production and shipment or forfaiting using a collateral instrument</td>
</tr>
<tr>
<td></td>
<td>3rd party financial risk</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Transfer risk from issuing to confirming bank (L/C and BPO) or spread the risk among banks (theoretically possible with L/C, expected to be easier with BPO)</td>
</tr>
<tr>
<td></td>
<td>Payment default</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Full protection for SBLC, L/C and BPO but shorter process, more objectivity and less complexity for BPO than others shall reduce the related operational risk</td>
</tr>
<tr>
<td>Commercial</td>
<td>Unpredictable cash-in flows to payment delay</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Faster compliance verification for BPO compared to others (for L/Cs mitigation through additional financing; impact on discounting for L/Cs at sight)</td>
</tr>
<tr>
<td></td>
<td>Refuse to honor payment - contractual dispute</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Irrevocable for L/C and for BPO</td>
</tr>
<tr>
<td></td>
<td>False or falsified information (do not match goods)</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Validate authenticity “on their face” (L/C) or electronically (BPO) - Link BPO to the carriers for fraud detection</td>
</tr>
<tr>
<td>Transport</td>
<td>Early or late shipment</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Specify last shipment date</td>
</tr>
<tr>
<td></td>
<td>Loss, theft, deterioration</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>○</td>
<td>Mitigate through additional insurances</td>
</tr>
<tr>
<td>Economic</td>
<td>Fluctuations in foreign currency, interest, inflation rates</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Can predict cash flows in FX risk hedging, important in case of transfer risk; use of home currency. Additional insurance possible</td>
</tr>
<tr>
<td>Political</td>
<td>Insurrections, terrorism war</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Syndicate the risk to other countries, theoritically possible for L/C, expected to be faster for BPO; Possible additional insurances</td>
</tr>
<tr>
<td></td>
<td>Sanctions , force majeure</td>
<td>○</td>
<td>○</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>Mitigate through additional insurances, through ECAs and private insurances (still to be proven on BPO)</td>
</tr>
</tbody>
</table>

Legend: ○ no protection for this risk  ● low protection for this risk  ● average protection for this risk  ● high protection for this risk  ● very high protection for this risk

Source: SWIFT

The Bank Payment Obligation is arguably the most promising innovation in trade finance in the last decade or more.

The driving issues and major themes related to the trade and supply chain finance business can perhaps be summarised as follows:

- Dis-Intermediation
- Innovation
- Regulation
- Evolution
STATE OF GLOBAL TRADE

The State of Global Trade

Global trade flows have a long history of outpacing global GDP growth, annually and over sustained periods of time. The global financial crisis adversely impacted economic conditions in leading markets across the globe, notably the United States and the European Union, with the effect that trade flows were also impacted, and macro-economic conditions globally were adversely affected.

While certain economies, such as China, were able to sustain robust trade-driven growth, and other emerging market economies were able to contribute to offsetting dismal results in traditionally strong OECD economies, it is no exaggeration to note that trade flows have been materially reshaped by the global crisis.

The US, at the epicentre of the toxic mortgage crisis which triggered the global crisis, and Europe, exposed to those same assets through its banking sector, and currently in the throes of major sovereign risk issues, have been unable to maintain consumption levels at pre-crisis levels. These two traditional destinations for the bulk of global trade were suddenly required to curtail import activity, forcing exporters from Canada to Asia, the Middle East and Africa – and beyond – to seek alternative markets for their merchandise and service sector exports.
The redefinition of the map of international trade flows has had direct impact on the activities and focus of trade finance providers, and is expected to have medium and longer-term implications for the flow of commerce across the globe.

**Highlights**

Intra-regional trade flows across Asia, the Middle East and Africa have evolved as areas of greater focus, as exporters in those markets have actively sought alternatives to the US and Europe.

![Intra-Regional Trade, 2001 - 2020](image)

*Source: ITC, EIU, BCG, June 2012*

Several trade finance banks and other providers have shifted their strategic approach to be based upon servicing the needs of customers engaged in commerce across selected “trade corridors”, with even the largest global players seeking to identify underserved or emerging niches on the basis of such corridors.

Whether a financial institution possesses a unique regional footprint or differentiated understanding of markets at the endpoints of such corridors, or whether such institutions can leverage especially effective correspondent banking relationships in service of such trade flows, there is a view among trade financiers that targeted approaches are both necessary and appropriate under current conditions.

This view is motivated by both the reshaping of trade flows, and the demand on trade finance banks to be significantly more selective in their pursuit of business opportunities.
Numerous leading and mid-tier trade banks were forced to retrench domestically or to scale back international operations and exposures, with the effect that a trade corridor based approach has become attractive to a number of trade finance providers.

The focus on and priority attributed to Asia Pacific is almost axiomatic at this stage, with continued strong growth in China and India, and significant potential perceived in Indonesia, Malaysia and numerous other jurisdictions in the region. Similarly, Africa has shown attractive growth driven by a combination of trade and inward (resource-focused) investment flows.

Trade and supply chain finance will be at the centre of activity in these growing markets, even as trade financiers continue to remain engaged in the United States, the EU and other markets globally.

**Global Currencies, Global Trade**

In addition to the reshaping of trade flows, and some emphasis among trade banks on service strategies linked to trade corridors between two well-known endpoint markets, another major development over the past several years relates to the emergence of the Renminbi (CNY) as a currency of international trade.

The US Dollar remains dominant as the currency of global commerce, commanding by far the largest market share of trade transactions (and other financial and capital markets transactions), and while the Euro was once seen as the only real alternative to
the American currency, economic and political uncertainty about the European Union and about the future of the Euro have resulted in a loss of momentum for the Euro as a global currency.

The rise of the RMB has been meteoric in many respects, and this despite lingering concerns about transparency and certain fundamentals linked to the currency. According to industry sources, the RMB now plays a role in transactions that represent approximately 10% of China’s trade flows, and by some estimates, as much as 2-3% of global trade flows, with every indication that the growth of the RMB will continue apace.

The implications for trade finance are significant, both in terms of the impact on foreign currency risk (reduced overall, in transactions where one of the trading partners counts the RMB as its base or home currency), and in terms of the demand for global trade banks to develop/grow capabilities and facilities linked to RMB-denominated trade.

Longer-term, senior leaders in the trade banking business perceive net benefit in the evolution of a system that can transact across borders in multiple currencies, with the RMB and the Indian Rupee cited as contenders for eventual status as trusted currencies of global commerce. Recent challenges around US Dollar liquidity in international banking and trade illustrated the perils of a single-currency system to many bankers unable to respond to the trade and supply chain finance needs of their customers, due to limited access to the American Dollar within their financial institutions.
Small and Medium-Sized Enterprises

In addition to the focus on trade corridors and the rise of the RMB, the business of international trade, in the context of ongoing economic and financial sector issues, has developed a focus on the role of small and medium-sized enterprises across the globe.

While the issue of the underserved SME segment is perennially present in banking, including trade finance, and while that issue is raised almost universally, from developing economies to OECD member states, the global crisis has forced a political focus on the importance of small business, and has resulted in demands from leaders in key markets, for banks to respond more effectively and more consistently to the needs of SME clients, even as financial institutions are challenged to improve the credit quality and risk profile of their portfolios.

The focus on small and medium-sized enterprises links directly to the evolution of the trade finance value proposition, with leading banks positioning supply chain finance as an effective model to serve the needs of suppliers – many of them SME’s – across the globe.

Trade and The SME

Prime Minister David Cameron comments: “If we could increase the number of SMEs that sell overseas by 100,000 it has the potential to add £30 billion ($47.8 billion) to the UK economy. In other words if we boost the number who export from around one in five today to over one in four, we could pretty much wipe out the trade deficit and create tens of thousands of jobs at the same time. That is the prize we are going for…”

Source: Trade Finance Magazine, November 2011

SME’s continue to suffer from the lack of liquidity in the market and from the high cost of financing, which resulted in further delay in settlement timeframes and a related extension of the cash conversion cycle by an average of 1.5 days, according to analysis conducted by PwC in its 2011 European Working Capital Study. Though authorities are developing legislation such as the European Late Payment Directive to tackle the issue of late payment for goods and services, conditions continue to be challenging for the SME segment.
Small and Medium-Sized Enterprises

SME’s are owed a record £33.6bn in late payments, with a rise of 10% over the last year. SME’s are owed an average of £39,000, and are waiting up to two months to get paid. Half of all UK SME’s - 861,000 firms - are currently experiencing late payments.

Source: BACS, November 2011

Export Credit Agencies

The role of export credit agencies and international financial institutions in supporting and enabling access to trade finance has been highlighted over the course of the crisis and beyond. “Market Gaps” left by financial institutions have had to be addressed through public or quasi-public sector export credit agencies, and through the engagement of IFI’s and regional institutions such as the Asian Development Bank, the Inter-American Development Bank, the World Bank’s IFC and others.

The role of such entities has proven to be so important, and demand for their services so robust, that leading ECA’s and IFI’s are at the forefront of the evolution of trade and supply chain finance, devising comprehensive programs aimed at meeting the financing requirements of their target client base in some of the most challenging markets on the globe.

IFI Trade Finance Programs

<table>
<thead>
<tr>
<th>Program title</th>
<th>EBRD</th>
<th>IFC</th>
<th>IDB</th>
<th>ADB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Facilitation Program (TFP)</td>
<td>20</td>
<td>91</td>
<td>20</td>
<td>16</td>
</tr>
<tr>
<td>Global Trade Finance Program (GTFP)</td>
<td>1999</td>
<td>2005</td>
<td>2005</td>
<td>2004</td>
</tr>
<tr>
<td>Number of transactions since beginning (year end 31 December 2011)</td>
<td>11,500</td>
<td>11,255</td>
<td>1,966</td>
<td>4,236</td>
</tr>
<tr>
<td>Value of transactions since commencement</td>
<td>EUR 7.2 billion equivalent to USD 9.5 billion</td>
<td>USD 15.8 billion</td>
<td>USD 1.96 billion</td>
<td>USD 8.8 billion (USD 3.5 billion of which in 2011)</td>
</tr>
<tr>
<td>Number of confirming banks</td>
<td>800</td>
<td>800</td>
<td>264</td>
<td>112</td>
</tr>
<tr>
<td>Claims to date</td>
<td>2 claims, zero losses</td>
<td>zero</td>
<td>zero</td>
<td>zero</td>
</tr>
</tbody>
</table>

Source: ICC Rethinking Trade and Finance 2012

Just as the close connection between trade and trade finance is now far more widely appreciated, the link between trade flows and trade-related market dynamics, and the evolution of trade finance, is now far more robust, with providers of trade and supply chain finance increasingly ready to respond with innovative solutions and programs aimed at enabling global trade flows.
The dynamics currently shaping international commerce, and the requirements of importers and exporters, and other parties to the trade value chain, will increasingly influence the evolution of the business of trade finance. The luxury of long product lifecycles and slow, incremental evolution is far less a reality in trade finance today, and the pace of change will only accelerate in the coming years, driving trade and supply chain finance to levels of evolution and innovation not seen to date.
TRADITIONAL TRADE FINANCE: LESSONS FROM THE L/C

Highlights

The Documentary Letter of Credit, or L/C, has been in existence for hundreds of years, possibly significantly longer, and has proven to be a robust, enduring and in many respects, effective instrument of trade finance.

Despite its relative complexity as a banking product, its labour and paper-intensive history, and generally low popularity among exporters and importers, the L/C is arguably the single most versatile mechanism of trade finance in the suite of traditional trade finance instruments. Despite this, the volume of trade transactions involving both the L/C and the Documentary Collection are clearly in decline in most markets across the globe, as illustrated below.

The Documentary Credit offers important lessons worth noting both in terms of its effective features and its less desirable characteristics, in the context of a consideration of the evolution of trade finance.

As shown below, financial institutions report that the L/C (also known as the Commercial Letter of Credit) accounts for a significant portion of their traditional trade finance portfolio of products, with “Open Account” transactions well in the minority despite its
popularity among importers and exporters, and despite the focus of supply chain finance in responding to the requirements of businesses trading on open account terms.

<table>
<thead>
<tr>
<th>Trade Finance Product Mix: Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Commercial letters of credit</strong></td>
</tr>
<tr>
<td><strong>Standby letters of credit</strong></td>
</tr>
<tr>
<td><strong>Guarantees</strong></td>
</tr>
<tr>
<td><strong>Collections</strong></td>
</tr>
<tr>
<td><strong>Open account</strong></td>
</tr>
<tr>
<td><strong>Other</strong></td>
</tr>
</tbody>
</table>

Source: Rethinking Trade & Finance: ICC Global Survey 2012

L/C’s remain relevant and important to the conduct of trade, particularly in times of crisis and in markets (or under conditions) that are particularly high-risk.

The longevity of the letter of credit and its applicability and effectiveness in a wide variety of commercial contexts, serves to illustrate the potential breadth of emerging propositions in trade and supply chain finance, particularly if those propositions are meant to encompass all the capabilities of the L/C.

The Documentary Letter of Credit has evolved into a versatile and highly effective instrument of trade finance, encompassing a variety of features and characteristics that should be considered when designing the ‘next generation’ trade and supply chain finance solutions.
**Independence: Credit Enhancement and Risk Transfer**

The letter of credit, by virtue of the role of financial institutions issuing such instruments as standalone payment undertakings, provides a level of independence from an underlying commercial relationship between buyer and seller that is core to the effective functioning of the L/C. The independent nature of the payment undertaking, and the financing and other services which flow from this key characteristic, is at the core of the well-balanced security offered by the L/C to both trading parties.

This independent status enables importers and exporters to benefit from credit enhancement – the replacement of commercial (importer) risk with generally higher-quality bank risk, as well as to arrange various forms of risk transfer between parties at numerous points in the transaction lifecycle, be it through the incorporation of Incoterms in the L/C, the use of credit insurance solutions or the leverage of selected features of a letter of credit, such as Confirmations.

**Infrastructure: Supporting Framework and Practices**

The L/C exists and is rendered more powerful as a tool of trade and trade finance due to its connection to a surrounding transactional “infrastructure” which includes a well-established and broadly supported set of quasi-rules (the Uniform Customs and Practice for Documentary Credits, or UCP) that have evolved to be integrated to some degree into commercial legal systems. Similarly, the linkage to Incoterms importantly supports the proposition of letters of credit, and financial infrastructure such as the existence of a market for Banker’s Acceptances, and the internationally recognized processes and practices around Bills of Exchange, further serve to sustain the proposition and longevity of the L/C as an instrument of international commerce.

The L/C does not operate in isolation, but exists and is supported by an ecosystem of processes and practices that broaden its appeal and effectiveness across a wide variety of jurisdictions and in a wide range of commercial and financial contexts. This includes well-established mechanisms and processes related to dispute resolution, and highly advanced secure communications and payment transmission networks such as SWIFT.
Promoting an Understanding of L/C’s

**Commentary on UCP 600**

*Article-by-Article Analysis by the UCP 600 Drafting Group*


"The aim has been to provide a Commentary that enlightens practitioners as to the thought processes behind the changes in each article and to explain why a change was introduced and, in some cases, why no change was made."

Gary Callier
Chair of the UCP 600 Drafting Group

The International Chamber of Commerce (ICC) has established rules on documentary credits worldwide for more than 70 years. UCP 600, the latest version of ICC’s universally used rules on documentary credits, came into effect on July 1, 2007.

Members of the Drafting Group that developed the new UCP have produced an article-by-article Commentary on the rules. Commentary on UCP 600, which reflects the Group’s personal views, explains the rationale behind the changes in the rules and clarifies the general principles that underlie them.

It frankly addresses the contentious issues in the new rules, among them:
- the term "on their face" and why it was dropped in all but one UCP article;
- the removal of the words "reasonable time";
- the language allowing discounting of deferred payment credits, and
- the new article on "definitions", containing terms such as "honour" and "negotiation".

Source: ICC Publications

**Versatility: Financing and Risk Mitigation Across Markets**

The L/C has been extremely effective in devising transactional solutions to meet the widest range of financing and risk mitigation requirements of importers, exporters and banks, in markets and under commercial conditions of all types across the globe. In particular, the L/C has been an effective means of providing liquidity, including access to foreign currency in times of limited supply, as well as enabling solid risk mitigation during crises or in higher-risk relationships or markets.

By way of general illustration, the selection of trade financing and settlement mechanism relates to both the maturity and trust level in the trading relationship, together with the commercial and financial impact of loss of product or revenue in the transaction. The L/C is well-suited to scenarios where trust levels are low, and the adverse impact of a failed transaction or a dispute is high.
Relationships: The Core of Trade Finance

The L/C relies fundamentally on the genuine desire of trading parties to conclude a transaction, and, despite its versatility as a financial instrument, rests firmly on a foundation of goodwill between importer and exporter, such that even globally high rates of non-compliance of export documentation do not, in the end, seriously impede the flow of international trade.

The L/C does not purport, nor attempt, to resolve all potential issues that may arise between an importer and an exporter, but operates on the basis that parties have entered into a commercial agreement, and in general, wish to see the transaction complete successfully. The L/C works effectively to balance the risk protection and other propositions, including financing, to both parties, whether they be equally expert, or whether one partner is a novice and the other, highly experienced in international trade.

Adaptability: Evolution to Meet Changing Needs

The L/C has had a history of adapting to changing requirements over a long period of time, hence its continued relevance and effectiveness, including in times when technology has so advanced, as to make possible the ‘virtualisation’ of L/C transactions.

In this dimension however, the L/C provides a lesson also in its failure to fundamentally evolve to meet the changing trade needs of importers and exporters. The same robust processes and mechanisms which made the L/C successful, contribute today to the view that it is cumbersome and out of date with current commercial practices.
The L/C today provides its greatest long-term value to the business of trade finance, by serving as a model for future approaches to trade and supply chain finance: a product that has perhaps reached maturity, and provides ample experience upon which to draw, in developing and designing next-generation trade and supply chain finance mechanisms.

In addition to the foregoing broad categories of lessons from the letter of credit, the L/C offers a rich history of practices and case studies at the transactional level, that can serve to inform the design and deployment of trade and supply chain finance solutions: a reality that is well recognised in the market, and one that can still be applied today in relation to emerging solutions in global trade finance.
OPEN ACCOUNT & SUPPLY CHAIN FINANCE

Highlights

The demands and commercial requirements of importers and exporters drove the evolution of traditional trade finance, to now include products and solutions aimed at addressing trade finance in the context of trade on Open Account Terms and in the context of international and global supply chains.

While the industry continues to develop standardised definitions and language around supply chain finance, and around solutions linked to Open Account trade, the rate of progress over the last three years in particular, has been notable.

The level of maturity and evolution of the Supply Chain Finance (SCF) proposition varies both among providers and among the corporates whose trading activities are driving the shift in emphasis to SCF programs from traditional trade finance.

Just as certain providers are focused on a subset of potential SCF activities, importers and exporters are expressing varying levels of interest in comprehensive, end-to-end programs, versus more tactical, transaction-focused options, with larger corporates predictably more interested in the full-scale SCF proposition.
Supply Chain Finance: Corporate Uptake

Supply Chain Finance (SCF) techniques are becoming prevalent in the portfolios of options among survey respondents - with 43% of buyers and 34% of sellers using this method to manage open account associated risks. Buying companies with revenues above US$1 bn are more mature in the use of SCF instruments to reduce risk of open account transactions.

The adoption of SCF programme instruments outpaces practices to improve and streamline internal operational processes, for example leaner management of the supply chain. Forty-five percent of respondents said that they would review possible launch of a supply chain finance programme in order to use the possibilities in its balance sheet in the future.

There has long been dialogue around the integration of the physical with the financial supply chain; of late, a third dimension – the information supply chain – has been added to the mix, and banks continue to work on developing compelling propositions in this space, even as senior trade specialists debate whether SCF brings something new to the market, or simply repackages a collection of existing banking products into a bundled proposition called Supply Chain Finance.

Whether SCF currently offers net-new business solutions is less critical than the reality that trade on open account terms, and focus on SCF, has motivated (even forced) trade financiers to take a far more encompassing view of their business. Additionally, industry leaders are taking a far more holistic, solution-oriented approach to the needs of their clients, than has historically been the case in product-driven silos of service delivery.
SCF Proposition

As noted earlier in this document, leading providers of trade finance, including international financial institutions and export credit agencies, have invested intellectual capital in the articulation of SCF propositions. Single-product approaches, program-based options and comprehensive solutions addressing the needs of importers, exporters, banks and other contributors to the working of global supply chains – all are available based on the variety of approaches in the market today.

Reverse factoring products, or larger programs meant to provide liquidity to (typically) small and medium-sized suppliers working with large/global buyer entities, can be obtained from a number of bank and non-bank sources.

Buyer-centric programs allow SME suppliers, often in developing and emerging markets, to gain access to liquidity and financing based on the borrowing capabilities of the large buyer, on the basis that overall funding costs is reduced, and the financial viability of suppliers is assured, through timely, affordable financing and working capital support.

Numerous buyers have been receptive to leveraging their borrowing capability to assure the health of strategic suppliers and the overall smooth functioning of often global, far-flung supply chains. Some suppliers have expressed reservation about joining such programs, due to the requirement to divulge financial details and to request financing.
through the program, ostensibly exposing a commercial weakness to their buying client, and possibly losing negotiating leverage as a result.

At the same time, the setup of such programs has been challenging to trade bankers, partly due to the logistics of “on-boarding” a large community of suppliers onto the program – and its enabling technology platform – and partly as a direct result of the increasing pressure on banks to know their customers, and the suppliers financed under such programs.

The KYC (Know Your Client) requirement has been resource-intensive for financial institutions, however, the KYCC (Know your Client’s Client) expectation is proving onerous and in some cases, presents a significant obstacle to the setup of supply chain finance programs.

Despite these complexities, SCF programs can be quite large, with facilities in the range of several hundred million dollars not at all uncommon, and certain industry sectors supporting single SCF programs worth well over a billion dollars. While the actual utilisation rates on such facilities is relatively low (industry estimates suggest about 10% on average), expectations are that the growth potential in trade and supply chain finance is heavily concentrated on SCF programs.

The appeal is sufficiently compelling, for several global banks to envision and market SCF programs as a service to other banks and financial institutions, much in the way that traditional trade finance processing was provided on an insourced basis for many mid-tier and smaller banks seeking to maintain a trade finance offering, but unable to make the requisite investments in technology and staff.

Supply Chain Finance Program

Flows are either Cross-border or Domestic

Supplier Finance
Supplier Finance is the financing of the procurement of the Anchor

Buyer Finance
Buyer Finance is the financing the sales (downstream business) of the Anchor

Source: Standard Chartered Bank
The size and scope of large-scale supply chain finance programs, combined with the regulatory and commercial limitations on banks, in accepting international risk and engaging in trade finance, underpin a requirement for the industry to enable efficient and prompt distribution of trade finance assets across a pool of investors, largely populated by banks that understand the business of trade finance.

Anticipated growth rates in supply chain finance activity, coupled with limited capacity, combine to motivate an industry-wide dialogue around the need to attract non-bank investors, including hedge funds, private equity pools and pension funds among others, to the trade finance asset class.

Given the profile enjoyed by trade and trade finance on a global basis at this moment in history, the evolution of trade finance will be well served by efforts to better articulate the trade banking value proposition and risk profile, and thereby attract a wider pool of investors, and enabling trade financiers to support even greater levels of international commerce.

The observation of a senior hedge fund manager, that he spends the majority of his time with clients explaining trade finance, and only an incremental amount of time ‘selling’ the virtues of the asset class as an attractive investment, speaks to the effort required to better champion trade finance as part of its evolution. Likewise, the lack of understanding of trade finance among many senior bank executives, and the notion that trade financiers enjoy promoting a ‘mystique’ about this business, further suggest there are opportunities to contribute to the evolution of trade and supply chain finance, simply through effective communication of its value.
TRADE AND SUPPLY CHAIN FINANCE: CORPORATE VIEW

Highlights

Corporate clients engaged in import and export activity express a wide range of views relative to trade finance, in particular, relative to traditional instruments such as the documentary letter of credit, which have been in use for generations. They are also increasingly vocal about their needs and expectations in the context of trade and supply chain finance.

Even as corporates demonstrate increasing interest in the conduct of trade on open account terms, finance and treasury executives, or multi-tasking entrepreneurs, acknowledge the unique position of the documentary credit in supporting international commerce.

At one extreme, are those with significant experience in using L/C’s, who have mastered their nuances, and optimised processes such that they are strong advocates of these bank instruments. The head of international sales and distribution of a global retailer noted several years ago that the company had so organised their processes (and leveraged influence on their bankers to customise supporting technology), that they refused to follow the trend of shifting to open account terms.

At the other end of the spectrum are companies anxious to minimise, even eliminate their use of documentary letters of credit, based on their perception of the complexity, cost, inefficiency and poor functioning of the instrument. For executives in this category of firms, the letter of credit is to be avoided whenever possible, and used only when there are no other alternatives.

Some companies appreciate the versatility and security available through the use of letters of credit, but most express concerns around excessive complexity and labour-intensiveness, delays in settlement and adverse impact on cashflow and working capital, high rates of discrepancy that negate the protective features of the instrument, and a general sense that these mechanisms are too expensive. The latter view, it must be noted, is an outcome of the commoditisation of traditional trade instruments and a lack of appreciation for the full value provided by these instruments.

Most commentators are favourably inclined to open account and supply chain finance, and are looking for effective solutions – and industry leadership – in this area. Though some corporates have engaged in offering financing solutions to their clients, many large corporates with significant cash positions during the crisis now see the need to release cash to assure adequate levels of operational cash flow.

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1 While the term “corporate” tends to designate a fairly clear segment of bank clients, the term is used here to refer to importers and exporters, be they multinationals, mid-cap businesses or small and medium sized enterprises – contrasting them from banks and other entities involved in either the physical or the financial supply chain supporting international commerce.
A series of interviews and a large number of interactions with importers and exporters provide significant input directly from corporates, around the opportunities and the pain points associated with the use of letters of credit in international trade.

**Opportunities and Pain Points**

**Common Industry Rules:** Corporates tend to agree that the L/C is an effective instrument of risk mitigation, despite the issue of high rates of non-compliance. There is also consistent commentary about the importance of common processes and widely accepted procedures, including the importance of the Uniform Customs and Practice.

**Full Security:** Confirmed L/C’s provide full security for the exporter, and additional risk mitigation through export credit insurance further strengthens the proposition around risk mitigation. One company noted that in their experience, the use of open account terms with credit risk insurance leaves potential exposure of up to 20% of the transaction value.

**Payment Delay:** One company mentioned significant payment delays even with L/C’s at sight, from a few days to more than twenty days. In comparison, another company mentioned that settlement in open account transactions can take well over three months to resolve, particularly when there is a requirement to make a claim under a credit insurance product.

**Credit Insurance Cover:** Traditional trade finance instruments, including L/C’s, can be effective in mitigating risk, but they allow for complementary solutions like credit insurance cover, to ensure further mitigation under specific circumstances, such as serious political risk or revolution.

**Transactional Expertise:** Advanced practitioners recognise that part of the challenge related to the use of letters of credit is a generally poor level of understanding of the mechanics of these instruments, including the impulse to over-complicate the terms and conditions and thereby effectively assure high levels of discrepancy.

**Document Management:** It has been noted in several discussions, that trade bankers are not necessarily the most open to providing advisory support and transactional expertise, especially to SME’s, and that this absence of support further contributes to the ongoing negative perceptions and issues related to the use of letters of credit. The provision of expert advice is seen as a significant opportunity in the enhancement of the “L/C experience”, and certain large corporates have described their own efforts in providing such advice to their partners, both corporates and banks, as a means of enhancing transactional efficiency. The preparation of documents and the effective management of the documentary process is one area where this issue arises on a frequent basis.
Observations on the Evolution of Trade Finance and Introduction to the BPO

The area of open account trade and supply chain finance is still nascent, and as such, viewed by some as an opportunity, and by others as a new proposition yet to be proven.

Corporate executives identify numerous categories of “pain points” relative to the use of letters of credit, by implication, seeking solutions in the market that would mitigate or eliminate these issues in the conduct of international commerce.

1. Operational and Transactional Inefficiency

Corporates routinely point out the inefficiency, time lag and cost associated with transactions on the basis of letters of credit, noting the resource and process-intensive nature of such transactions, and readily confirming adverse commercial consequences from these operational and transactional inefficiencies. In certain markets, where high levels of country or commercial risk are a factor, it may also be the case that technology is not necessarily at the leading edge, and as such, paper-intensive processes can impede transaction efficiency, and reduce visibility on both the physical and financial aspects of the transaction.

High rates of discrepancy and non-compliance in the first presentation of documents – reportedly as high as 70% globally and 80% in the Nordic Region, require a discrepancy management process in banks and among corporates, to enable (where possible) the correction and re-presentation of documents – a reality which introduces cost and delay in the trade settlement process. Some companies have outsourced the document preparation to third party service providers with the intention of improving the process and reducing cost and delays, with varying degrees of success.

While some of this adverse impact is mitigated through the use of mutually agreed template L/C’s, even this process does not eliminate discrepancies, or the need for discrepancy management activity. One corporate executive noted that even with the use of agreed templates, the company must frequently revert to request one or more amendment to the L/C, about 60% of such amendments arising pre-shipment, and about 10% arising in the post-shipment timeframe. Despite these efforts, inconsistent interpretation of L/C terms and determinations on non-compliance remain an area of concern and frustration for the company.

The reality of high discrepancy rates often negates the protective proposition of the L/C as relates to the exporter, placing the transaction very much in the hands of the importer, or of a bank that makes (appropriately) an independent decision as to the compliance or non-compliance of the documents presented. The basis upon which compliance is determined can vary significantly between banks, with some favouring an approach based on “Strict Compliance” – a black-letter approach – and others preferring to be guided by “Substantial Compliance”, where minor discrepancies with no discernible commercial impact are ignored. The variability of approaches can add further inefficiency and risk in the context of a traditional trade transaction.
Discrepancy Management

“Discrepancies clearly affect the cash conversion cycle, and impact working capital – delaying settlement by five to fifteen days; the use of L/C's in South Asia remains significant, as there are no real alternatives, however, financial institutions are often more interested in finding discrepancies for their customers, than undertaking appropriate and independent verification of documents. We seek to avoid discrepancies in presenting documents, and would welcome a process where the verification is consistent and objective.”

Source: SWIFT Interviews, Pinaki Roy, Vice President Project Treasury, Reliance Industries

2. High Cost

There is a broad perception in the marketplace, that traditional trade products – especially letters of credit and standby letters of credit/guarantees are expensive. This is a perception that has been allowed to develop, and candidly, does not do justice to the value provided by letters of credit, however, the expectation has been set and is now unlikely to be reversed.

The head of export finance for a major European pharmaceutical company was heard to observe at an industry conference, that their average L/C cost of €400 was considered excessive, yet when this assertion was challenged privately, noting that the company benefits from highly effective risk mitigation on multi-million Euro transactions, this view was tempered somewhat.

In addition to the high cost of straightforward instruments, corporates note that the use of letters of credit, with features like Confirmations, supported by export credit insurance, can involve significant cost, especially in higher-risk markets. Such costs can dilute margins, or represent a material cost to be passed on to the importer through pricing adjustments, and may become a competitive disadvantage.

3. Transaction Timeframes and Delays in Settlement

Some companies continue to be challenged by limited access to liquidity, and issues related to availability of working capital, and therefore seek ways to optimise their financial and treasury positions. In this context, the settlement timeframes experienced under letters of credit – even those issued “At Sight” where settlement is meant to be relatively immediate – involve delays ranging from several days to two or three weeks, representing significant impact on liquidity and working capital.
Transaction Timeframes

“We invest significant time and effort in discussing and finalising L/C terms and conditions prior to issuance in order to avoid delays, however, we still experience material delays every now and then. Our primary concern is to support our Distributors, and to ensure we are not carrying inventory for extended periods of time. Instead of a mere focus on DSO we also strongly invest in inventory control (DIO); we aim to reduce the time elapsed between order placement and issuance of the L/C to help optimise our order management, credit control and inventory-related processes. Simplicity is important to us: a simple solution will translate directly to commercial value for our Company and for our business partners.”

Source: SWIFT Interviews, Bram Zieck, Manager Business Controls, Ricoh International B.V.

4. Transactional and Operational Risk

Corporates note that the technical complexity around letters of credit present significant risk at the level of the transaction and at the level of the trade “operation”. This also relates to the high discrepancy rates and the possibility (for exporters) of having shipments refused, or having buyers leverage discrepancies to demand significant discounts on the agreed price.

While it is understood that trade finance is generally the purview of large international institutions with well-established credentials in the business, corporates pursuing opportunities in developing and emerging markets, or in so-called “Frontier Markets” report that competency gaps are a serious issue.

Bank Competency in Trade Finance

“We have noted that in certain markets, there is an increasing need today to deal with regional or local financial institutions – tier 2 or tier 3 banks with large domestic presence – that have limited technical expertise in trade finance, and limited knowledge of the products and processes related to letters of credit and other such instruments.

This introduces an added element of risk, and we have found it necessary to interact directly with the Issuing Bank and with our trading partners to ensure smooth conclusion of our transactions in these markets. We sometimes find it necessary to onboard a bank based in the EU to help facilitate the transaction, even to help convince the Issuing Bank to accept the wording or the terms and conditions in the L/C. In such cases, the initial setup of the first L/C can be time-consuming, but subsequently, the process becomes faster.”

Source: SWIFT Interviews
The paper and process-intensive reality of transacting on the basis of letters of credit, and also as relates to the use of export credit insurance presents issues of efficiency, but, as some companies note, also introduce risk into the transaction by reducing visibility, extending transaction timelines and requiring extensive (often manual) tracking of transaction status and of various forms of exposure.

Some corporates, understanding the mechanics and intricacies related to documentary credits, simply make commercial decisions to accept certain types of risk, in order to advance a trade relationship and accelerate the conclusion of transactions.

The issue of banks’ differing assessments of compliance or non-compliance of documents presented under documentary letters of credit, has very practical commercial implications and can have direct, adverse impact on liquidity and working capital. One bank may apply the principle of substantial compliance in assessing conformity to L/C terms, and on this basis, may deem a drawing to be fully compliant, where another bank, on the basis of strict compliance, may conclude that the same drawing is non-compliant. In some instances, the differing conclusion comes down to different levels of commercial acumen and technical competence among banks.

Some corporates, having a certain degree of leverage in their banking relationships, may opt to proceed with a transaction despite such disagreements, choosing to manage the risk of non-payment through negotiation and the application of such leverage as may be available. Delays and working capital impact traceable to disagreements between banks can add a week or more to the processing timeline.

In the end, it is clear that the Letter of Credit is an extremely effective instrument, with a rich value proposition – when it works properly, or more precisely, when it is used properly by all implicated parties. The processes related to the use of L/C’s are prone to error and dysfunction despite the long history of this instrument, however, the L/C at its best, offers a wide variety of lessons for careful consideration, in the design and development of next generation trade and supply chain finance solutions.

5. Absence of Standardised Messaging & Integration

The communication between banks and corporates is not yet standardised for Trade Finance services: banks typically use a majority of free text messages (MT999) or an e-mail that embeds a copy of the interbank letter of credit or guarantee (MT7XX).

Following the evolution in cash management activities and capabilities, corporate treasurers are expecting similar levels of standardisation for trade finance activities in the interactions with their bankers. Standards are required not only at the level of the messaging but also in terms of market practices.
“Corporates are looking for a standardised connectivity, messaging and rulebook for trade finance at the same level of acceptance as cash management. It is important to have a single package for all banks in all countries including the emerging countries and to cover the language of the legally binding documents. The package should use common practice rules and must address current technical issues, such as the message size limitation or the limitation to the Latin-character set. Banks should refuse free format messages and educate clients in emerging markets to use messages correctly. We have more than 100 banking relationships and do not want to be locked into a platform. We selected a multi-bank platform.”

*Source: SWIFT Interviews*

As far as L/Cs and guarantees are concerned, several platform providers have developed their own proprietary formats on the basis of so-called three-corner closed models (two parties, one bank). Their commercial success is currently limited to a niche market because the models impose a costly on-boarding to both the buyer and the seller and do not offer the reach and scalability required in a multi-bank environment such as the one in which trade finance operates.

In view of the market demand for an open messaging platform in a multi-bank environment, SWIFT has recently standardised communication between corporates and banks with the development of the MT798 message format, in the context of the SCORE market practices. By doing so, SWIFT has extended the existing MT7XX messages from the interbank space to the corporate to bank space, with the objective to streamline the information exchange and reduce the banking services costs.

“Contrary to treasury and cash management that are often centralized on one or very few banks even for big corporates, trade financing involves by nature a wide range of financing banks - or counterparts in the banking sector - for each trading company at the same time. While the multi-bank approach is important, bank solutions do not respond yet to the needs of the corporates in the sector: even when standards are available there are no common guidelines in terms of interpretation, structure or field customisation and usage. There is definitely a need of a broadly recognized and unified standard.”

*Source: SWIFT Interviews, Matteo Somaini, Finance Manager, Duferco SA*

While the adoption level from the banking sector is still growing with more than 25 banks using the MT798 in October 2012, there is still a perception in the market that banks have not yet achieved a uniform implementation for documentary letters of credit and guarantee products.
“A key factor for us is the creation of a common global standard of messaging and communication, including industry practices, with direct integration to ERP systems such as SAP. This will enable appropriate visibility on transactions and various exposures, including global utilisation of bank credit lines.”

Source: SWIFT Interviews, Peter van Rood, Corporate Director Treasury, Akzo Nobel

The lack of a global messaging standard has been cited repeatedly as an issue by finance and treasury specialists. This pain point impacts trade finance transactions involving both traditional products and open account or supply chain transactions. One large corporate describes the challenge of using various spreadsheets to manually record and track various forms of exposure and transaction fees, noting that electronic communication is not currently an option, and that the absence of integration with ERP systems is problematic.

The common use of documents in PDF format in the bank and corporate transaction process introduces limitations and delays in the process flow.

“Today’s proprietary trade e-banking solutions are generally thin-client but very PDF-intensive and free format. Files of scanned documents are exchanged through channels with varying degrees of security and, while multi-bank platforms offer an improvement, today’s solutions do not fully meet the automation needs of trade intensive enterprises. The key to success is to convert paper documents to structured data and exchange these messages securely. The MT798 helps meet these requirements and provides the non-repudiation and standardisation which the payments market already enjoys in the corporate to bank space.”

Source: SWIFT Interviews, Marcus Hughes, Director Business Development, Bottomline Technologies

There is broad acknowledgement across the trade banking and trade technology space, that technology has now evolved to the point where the promises of evolution from the late 1990’s can be envisioned, developed and deployed in commercially viable manner. Most technology providers with a significant presence in the trade space are working to develop solutions linked to open account and supply chain activity, and several have progressed significantly in the area of “dematerialisation” of documentation and automation of transactions, coming closer to the long-sought straight-through processing of trade finance transactions, aimed at reducing error rates as well as labour and paper-intensiveness in the traditional processes linked to trade finance.

Similarly, integration of trade finance technology platforms between banks and corporates has evolved significantly, allowing the option for example to offer financing based on the issuance of Purchase Orders, based on interfaces to procurement systems.
The challenge for large corporates and multinationals, that maintain multiple banking relationships, is also an area of focus, with several robust multibank systems currently in the market, and the underlying notion of bank-agnostic technology platforms gaining traction as a direct result of corporate demand, and evolving technical capability.

Technology, such as the SWIFT infrastructure, remains at the core of transactional security and timely processing, with the more recent evolution being that certain technical architectures and solutions, such as the Bank Payment Obligation, achieving the status of a financial undertaking that can be accepted by banks as collateral against a loan or financing facility.

The perennial challenge related to global, standard messaging and formats remains elusive, however, technology is an ever-central component of the evolution of trade and supply chain finance, driving both the evolution of trade and supply chain within banks, and the deployment of a variety of non-bank solutions aimed at responding to the needs of importers and exporters, including SME’s, across the globe.
Case Study: Electronics Company, UAE

An electronics business unit in the UAE offers an excellent illustration of what can happen when solid technical knowledge of trade finance meets a desire to think in creative ways about how to meet trade and supply chain finance requirements.

A senior finance executive with the company in Dubai notes, "Post-2008, we began to look at market conditions as an opportunity to grow our business and our market share, which we have succeeded in doing in double digits over the last three years. Part of the reason for this success has been our ability to work in partnership with our suppliers, distributors, customers and other business partners, to meet our respective financing and risk mitigation requirements, even at a time when bank trade finance for small and medium enterprises (many of our suppliers) can be difficult to secure."

The company’s business develops and customizes million-dollar products that enable high-quality satellite transmission. These complex products typically require a year to develop, test and deploy, which presents yet another challenge in securing trade finance due to the tenor that would be required.

The company has found that transactions involving documentary letters of credit can work well and effectively; the company very rarely presents non-compliant documents for payment, and does recognize the value of this long-established and trusted instrument. Even when fully compliant documents are presented, however, the company estimates average time lags of three days to a week to settle the transactions. In the event documents are assessed as discrepant, the delay can extend by an additional two weeks. The company has opted to dispense with amendment requests for drawings under a set threshold value, preferring to accept letters of comfort from their suppliers assuring waiver of discrepancies. Part of the complexity encountered by the exporter is the lack of understanding of the mechanics of letters of credit among SME suppliers, and, a gap in effective advisory support from most banks in this area.

The company is generally risk-averse in its approach to trade finance, seeking to ensure that risks remain off-balance sheet. At the same time, their SME suppliers in the region have experienced difficulty in accessing trade finance from banks. With the team currently focused on opportunities in Africa, the country risk issues have also presented some challenge - or prohibitive cost - in securing necessary financing or risk mitigation support. While supply chain finance initially seemed a promising solution, the banks most active in this domain have been in search of high-value, high-volume business, whereas this company preferred to start small and build up its program.

The company opted to work with a leading global export credit and insurance company, to structure a receivables finance program aimed at supporting the suppliers, who sought to do business on open account terms but preferred not to seek support from their bankers. The partnering export credit specialist devised a solution that perfectly fit the requirements of the company and its supplier community, at very competitive costs, and as the client had insisted, providing assistance to suppliers without recourse to the company.
The company and its partners are looking at creative options for dealing with the uncovered portion of the financial risk (typically 10% of the transaction, as is the norm), and the company is now working to devise a financing structure on the basis of the insurance cover provided by the ECA - with bankers and/or large trading houses.

The partnership with this global risk insurer is also assisting in responding to the desire to transact on open account terms: the insurer conducts credit analysis and complete due diligence on the participating suppliers, and the company uses this insight to inform its own approach to credit management with those suppliers - extending, for example, secured credit terms for 60 days. In the event further credit is required, the company may make an internal decision to extend additional credit, or may approach the credit insurer for a temporary increase in the approved line.

In the end, the company has successfully developed a strategic partnership, and a combination of innovative transactional solutions, to address the company's risk mitigation requirements and to support its supplier network through access to trade and working capital finance.

The company's finance executive summarizes the current situation, noting, "Our approach has evolved into a very effective model based on genuine partnerships and practical solutions to the challenges of international commerce. We will continue to look at emerging solutions and value propositions in trade and supply chain finance, balancing our use of established and traditional mechanisms such as letters of credit and guarantees, with new or innovative solutions in the open account and supply chain space, including the SWIFT/ICC Bank Payment Obligation."

Source: SWIFT Interviews
THE BANK PAYMENT OBLIGATION

Definition
The Bank Payment Obligation (BPO), an instrument designed and deployed by the International Chamber of Commerce (ICC) and SWIFT in response to demand from the trade banking industry, has gained clear traction in the past two to three years in particular, as a viable addition to the settlement and financing mechanisms already available in the trade market today.

What is it?
- A BPO is an irrevocable undertaking given by an Obligor bank (typically the buyer’s bank) to a Recipient bank (the seller’s bank) to pay a specified amount on an agreed date under the condition of a successful electronic matching of data according to an industry-wide set of rules adopted by the ICC.
- BPO constitutes a legally binding, valid and enforceable payment obligation of the Obligor Bank to the Recipient Bank under the appropriate standard of law, enforceable in accordance with its terms.
- BPO is a technology independent instrument based on ISO 20022 XML that can be used on any open matching platform, such as the SWIFT Trade Service Utility platform (TSU).
- BPO is not a light letter of credit or an electronic letter of credit

How does it work?
- Only the data required to assess the financing risk is extracted from existing documentation – Purchase order, Commercial invoice, Transport, Insurance, Certificate
- Importer or Exporter need to agree on the use of a BPO in their commercial agreement. Both will establish the BPO terms and conditions in the bilateral agreement with their own bank.
- Obligor and Recipient banks rely on the ICC URBPO and the contractual agreement of the matching platform, such as TSU Service Description.

New ICC Uniformed Rules for BPO - Target availability 2Q 2013

Source: ICC Education Group, September 2012

While the BPO has been under development for some time, it was announced in late 2010 that the ICC would endorse this instrument, and work to develop a set of rules similar to those that guide the use of documentary letters of credit – a critical step in the positioning of the BPO and in its adoption as ‘market practice’ in trade and supply chain finance.

Positioning
The BPO is a data-matching based financial undertaking that aims to respond to the demand for streamlined settlement and financing and secure payment options in trade finance, positioned as a bank-assisted financing tool on a spectrum somewhere between the traditional documentary credit and the open account transaction.

The BPO allows banks to once again play a significant role in the facilitation of trade through trade finance, enabling clients to benefit from features and functionality that provide value from both a trade finance and a treasury/cash management perspective.
Observations on the Evolution of Trade Finance and Introduction to the BPO

The BPO: Elements of Both Worlds

While the BPO does not seek to replace the Documentary Letter of Credit, rather seeking to offer an alternative with some differentiated characteristics and features, the BPO does address some of the common grievances levelled at the L/C by importers and exporters across the globe.

Challenges of Documentary Credits

Source: SWIFT
**BPO transaction flow**

The BPO transaction flow relies on two key aspects:

1. The use of minimum fields, the buyer, the seller and respective banks agree on the payment terms and conditions and on the minimum trade information required to assess the credit risk;
2. The dispatch of documents, such as the bill of lading, certificate of origin and certificate of quality, from the seller directly to the buyer.

Given the limited information required by the banks and the accelerated document exchange, corporates can expect a lower rate of discrepancies and an acceleration of the settlement process.

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**Sample BPO Transaction Flow**

**Sequence Flow**

1. Buyer and seller agrees on a BPO. Buyer sends a purchase order to the seller.
2. Buyer provides the minimum data from the PO and the BPO conditions to the Obligor bank.
3. Seller confirms the data from the PO and the BPO conditions to the Recipient bank. If the submitted data matches the TMA, the “baseline” is established. Buyer and Seller receive the matching report from their banks.
4. BPO is irrevocable but conditional (subject to the electronic matching of agreed datasets).
5. Seller ships the goods to the destination.
6. Seller provides the shipment and invoice data to its bank, which submits it to TMA for matching.
7. Buyer receives a match report from its bank and is invited to accept mismatches if any.
8. Seller’s bank informs the Seller about the successful dataset match.
9. BPO becomes operative and due according to the agreed payment terms.
10. Seller sends the paper documents directly to the buyer enabling the buyer to receive the goods.
11. On the due date, the Obligor bank debits the proceeds from Buyer’s account and remits the funds to the Recipient bank. The Recipient bank credits the seller’s account.

*Source: ICC Education Group, September 2012*
Positioning the BPO

The BPO should materially reduce the risk, cost and frustration associated with transacting on the basis of L/C’s, while allowing for a number of the key advantages linked to the L/C’s to be preserved and offered in the context of a BPO transaction.

The BPO allows for effective risk mitigation, and is technology agnostic, as relates to the matching engine that is used to determine compliance or non-compliance of the data transmitted in the course of a BPO transaction.

The ISO 20022 XML structure, compatible with the BPO, supports any type of character set and is not limited in the size of the documents, which have been commonly reported as important issues when dealing with official legal documentation in some key emerging countries.

By virtue of its electronic nature, the BPO will facilitate secure, efficient and objective transactions, eliminating some of the complexity, inefficiency and uncertainty involved in L/C-based trade.

At the same time, this new instrument of international commerce will increase the balance in the security offered to importers and exporters, as contrasted against the rather less equitable option of transacting on open account terms.

The BPO relies on an open four corner model that is based on multi-bank access channels: it unbinds the business model from the underlying technology, leaving each trading counterparty the choice on the best way to implement the BPO and to communicate with its banks. Compared to third-party Supply Chain Finance platforms, the BPO is expected to reduce, significantly, the onboarding and operational costs related to the setup of a supply chain finance program.

<table>
<thead>
<tr>
<th>BPO Comparison</th>
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<tbody>
<tr>
<td><strong>Compared to Letter of Credit</strong></td>
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<tr>
<td>Electronic presentation of data instead of physical documents</td>
</tr>
<tr>
<td>Improve quality and objectivity of compliance verification</td>
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<tr>
<td>Quicker process as it focuses only on data relevant for financing</td>
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<tr>
<td>Can be added more easily at any time, for any amount value</td>
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<td>Easier access to financing services</td>
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Source: ICC Education Group, September 2012
Compared to the letter of credit, a Bank Payment Obligation favourably impacts working capital and liquidity for trading partners, and ought to enable more timely settlement of transactions, as shown below:

*Source: ICC Education Group, September 2012*
Realising Efficiencies from the Working Capital chain

**Sellers**

- Accelerated cash flow through faster collections – reduces DSO by 50% - 65%
- Lower operational costs on account of electronic nature of transactions – from 10% to 30% less FTEs involved in documents preparation
- Releases liquidity from the financial supply chain to boost working capital
- Reduced banking fees by up to 50% and eliminate the handling fees

**Buyers**

- 3x faster turnaround of the banking lines
- Lower issuance banking fees by up to 60% (depending on the maturity of the BPO issuance facility)
- Reduce or eliminate the discrepancy fees
- Enhanced borrowing potential and an opportunity to make use of supplier discounts

* All quantified benefits are subject to individual negotiations and use of Standard Chartered BPO Automated Framework

Source: Standard Chartered Bank

Corporates are expected to benefit from:

1. operational efficiency gains related to the reduced complexity, the reduced need for specialized L/C training and vetting personnel, reduced banking fees, quicker resolution of discrepancies
2. financial gains related to the cash conversion cycle acceleration and reduced need for borrowing, as well as improved monitoring and tracking of exposure and banking limits
3. increased business and competitiveness related to enhanced flexibility of payment terms

**Key Benefits**

“If the adoption goes well, gains for BP Chemicals can be expected to be well above $1 Million per year with most of the upside lying in more marginal income in the short run and substantial savings or progress in operations, finance cost and risk optimisation in the long run.”

Source: SWIFT Interviews, David Vermylen, Global Credit Manager, BP Petrochemicals
Key Benefits

“Benefits [for an importer] are not really seen in cost but much more strategically, in closer relationship between buyer and seller – this can be crucial in a process manufacturing industry during periods of constrained supply; BPO could deliver real benefits in regions and jurisdictions where sensitivities over release of financial information restrict ability to offer open credit but where parties are wanting to eliminate the administrative burdens of L/C’s.”

Source: SWIFT Interviews, Gary Slawther, Corporate Treasurer, OCTAL Petrochemicals

Supply Chain Finance and the BPO

With the increased cost of capital, the key priorities of corporates relate to access to affordable working capital solutions, in some cases, to financial support key counterparties in the supply chain, whether they are suppliers, intermediaries, clients or distributors.

Currently, supply chain solutions provided by banks are focused on existing/trusted clients and to “known” counterparties in the supply chain, and to transactions where the bank has significant visibility. This is partly a function of prudent lending and partly a result of regulatory requirements related to “Know your Client” rules.

Typically, supply chain finance solutions today focus on working capital solutions that can be provided relatively late in the transaction cycle, generally after approval of the invoice, due to process limitations and a degree of caution among lenders.

In light of the complexity, diversity and physical distance involved in many global supply chains (the notion of “fragmentation” of supply chains noted earlier), most banks are unable to provide liquidity to all participants in the supply chain.

The BPO, as an electronic instrument and an interbank undertaking, can assist banks in extending their supply chain finance proposition across the transaction, on the buy side and the sell side, as well as to reach a larger proportion of the supply chain ecosystem – ideally, positioning an offering that can provide near-full coverage of the liquidity requirements of the global supply chain.

The electronic data-driven nature of the BPO instrument gives trade bankers the opportunity to provide supply chain financing services earlier in the transaction lifecycle, in pre- and post-shipment finance, at a more advantageous rate.

At the same time, the open and multi-bank nature of the BPO instrument gives trade banks the reach and scalability to extend financing based on interbank relationships to any counterparty around the globe, including in the context of approved payables and discounted receivables.
BPO-Based Financing Services

Tomorrow’s data-driven risk mitigation and financing services using the Purchase Order

Today’s data-driven invoice-based processing and financing services

Ordering of goods
Purchase Order
Pre-shipment finance
Payment assurance

Production of goods
Certificates
Post-shipment finance
Timely payments

Shipment of goods
Transport Documents

Issuance of the invoice
Invoice
E-Invoicing

Payment & cash management
Approved Invoice
Approved Payables Financing

Payment initiation
Payment processing

Source: ICC Education Group, September 2012
**BPO Adoption**

With over forty banks engaged in the adoption of BPO, the technical and commercial viability of the BPO are already well supported despite the limited number of transactions completed to date. The level of interest and attention around this new model speak to a clear desire among leaders in trade and banking, for a twenty-first century solution to the provision of trade and supply chain finance.

The rate and level of industry adoption of the BPO has been reflective of a combination of natural caution and a desire to explore innovative business models and next-generation solutions in response to the evolving expectations of companies engaged in international commerce. Large and global corporates in particular have perceived the potential of the BPO, as have some of the leading trade finance banks across the globe, with the effect that adoption rates are accelerating.
Challenges and Success Factors

As might be expected in the context of a nascent business model with global reach and significant transactional complexity, there are some challenges and key success factors to consider in the deployment of the BPO. The following list, while not exhaustive, provides a view of some of the issues to be addressed as the BPO continues to gain traction and momentum.

Positioning of the Proposition

The BPO is positioned somewhat between the documentary letter of credit, and the open account transaction, however, there remains a tendency for the market to perceive this instrument (incorrectly) as a “virtual letter of credit”. There is a need to continue to clarify and differentiate the Bank Payment Obligation as a separate and distinct solution, and a complementary option to the trade financing mechanisms already in the market today. As with other aspects of business involving SWIFT, there is the industry-wide collaboration flavour of activity, and there is the reality that banks will compete against each other, using the BPO, which they have collaborated to bring to market.

Document Delivery Risk

“One obvious benefit would be the ability to discount a BPO undertaking albeit predicated upon the seller having achieved data input with zero mismatches. This could prove to be a serious challenge especially if multiple parties are involved. Such discounting could not be done with most open a/c sales to non-majors or for sales against SBLC. However, even if the seller were to be granted sole input rights, there is no compelling reason to assume that this would enhance the input quality, upon which ultimately the entire procedure stands or falls. I fail to see any significant benefit for a buyer to move to BPO if they could previously purchase on clean, open a/c terms, as there would be a cost incurred for obtaining a bank’s payment undertaking, except as a means to facilitate a supplier’s discount operation. The benefits to a Seller are more apparent.”

Source: SWIFT Interviews, Peter Sproston

Mitigating Documentation Delivery Risk

While the BPO does not require physical documents to be transferred through banking channels, the seller is still obligated to send such documents to the buyer in order to enable customs clearance and delivery. In the context of a BPO transaction, the mode of delivery of these documents of title will depend on the level of trust and comfort between the seller and the buyer.
Document Delivery Risk

“Documentation is on the critical path of trade management to ensure the rapid movement of freight to avoid charges and inventory outages; as documents are outside the banking system then the ability for a bank to provide a guarantee of documents being processed in order to release goods is gone. However, the direct buyer seller relationship and reliability of courier services can actually speed the process up and ensure that it is only “interested” parties with something at stake who are involved (banks do lose documents – we have experienced it)”

Source: SWIFT Interviews, Gary Slawther, Corporate Treasurer, OCTAL Petrochemicals

Supply Chain Process Design/Simplification

Though the BPO has been designed to encompass all the core features of the L/C, corporates and banks will need to reassess their current operational models and take the opportunity to challenge current processes in order to optimize both in light of the BPO.

The objective is not to replicate the L/C process but to take advantage of the technological innovation brought by BPO to revisit the operational processes across the entire supply chain, including importers, exporters, transport companies and banks.

SCF Operating Model Redesign

“What we need is an irreversible and negotiable undertaking which can be discounted to generate immediate cashflow. Keep it simple in terms of the documents and data required: the likelihood of problems arising and ‘discrepancies’ impeding the flow of trade will be linked directly to the number of documents or data elements required in a BPO; at the same time, consider how some of the existing and effective practices such as avalisation, the use of Incoterms and the option to create an acceptance for future settlement, might work in the context of a BPO. Above all, keep it simple.”

Source: SWIFT Interviews, SWIFT Interviews, Pinaki Roy, Vice President Project Treasury, Reliance Industries

Industry Adoption and Promotion of BPO

Formal endorsement of the BPO model by the ICC has further motivated industry uptake, and numerous senior specialists across the industry have been important contributors to the development of the BPO, and to the creation of a roadmap for its further development, in direct response to the needs of industry. It will be critical to the growth, sustainability and success of the BPO, for this type of industry-wide engagement to continue. In particular, the role of the ICC must remain central to the evolution and growth of the BPO.
Industry Adoption and Promotion of the BPO

“The BPO could deliver real benefits in regions and jurisdictions where sensitivities over release of financial information restrict ability to offer open credit but where parties are wanting to eliminate the administrative burdens of L/C’s; the ultimate goal is to entirely dematerialise trade documentation – SWIFT can provide the tool, but the ICC is the body that provides the rules and practices, to which key parties in a trade transaction adhere. The ICC is best positioned to drive advances forward.”

Source: SWIFT Interviews

ICC Endorsement of the BPO

“The BPO could deliver real benefits in regions and jurisdictions where sensitivities over release of financial information restrict ability to offer open credit but where parties are wanting to eliminate the administrative burdens of LCs. The ultimate goal is to entirely dematerialise trade flow documentation – SWIFT can provide the tool, but the ICC is the body that provides the rules and practices, to which key parties in a trade transaction adhere. The ICC is best positioned to drive advances forward.”

Source: SWIFT Interviews, Gary Slawther, Corporate Treasurer, OCTAL Petrochemicals

Market Practices and Product Development

While the BPO itself is championed and promoted as a compelling proposition in trade finance, leading banks and corporates are working together to envision and execute transactions that will demonstrate the versatility of this new instrument, by adding clear value and meeting demonstrably important commercial objectives for corporate clients.

Banks must now develop business solutions and products based on the BPO, including articulating scenarios where clear value propositions are defined for sellers and buyers, that combine not only the process efficiency gains but also the extended financing capabilities.

Market Practices

“The BPO will require an international rulebook which, in addition to the bank-to-bank rules encompassed in current efforts, will address the business relationship between the banks and the corporate clients. The BPO offers numerous positive features, including the reduction in the number of documents/data required, and a reduction in the complexity of the transaction. Once the banks develop a level of comfort with the BPO that is similar to what exists today with the Letter of Credit, and once a bank-to-customer rulebook is added to the BPO model, this new instrument will gain further traction.”

Source: SWIFT Interviews
Most interviewees observe that there is a strong need to educate the market about the BPO, both conceptually and in practical, transactional terms. The audience for such targeted education efforts must include corporates, both commercial and state companies, in mature and emerging markets.

**Broadening of Engagement**

The BPO must be promoted as a solution among regional and larger local financial institutions engaged in facilitating international trade. Tier 2 and Tier 3 banks service an important constituency of clients, and must be part of the BPO community. Likewise, the engagement of large and global corporates must be extended to include mid-caps and small and medium sized enterprises, to ensure a truly comprehensive customer base and solution set around the Bank Payment Obligation.

Similarly, it has been noted repeatedly by interview participants, that the BPO must eventually evolve from its current “Bank-to-Bank” model, to incorporate “Bank-to-Corporate” transactions and relationships. Under current economic and political conditions, and in light of commercial realities across the globe, this must explicitly include the engagement of SME’s, given their critically important role in the flow of global commerce.

At some stage, just as banks are now thinking about supply chain finance solutions initially targeted at cross-border business, as potentially applicable in domestic transactions, the BPO may evolve to encompass commercial transactions within domestic borders.

**Regulatory and Capital Treatment**

Trade finance as an industry continues to wrestle with the challenge of assuring appropriate and equitable treatment of its business, from a capital adequacy and broader regulatory perspective. The BPO must be positioned quickly and clearly to assure appropriate treatment of its transactions, particularly given the lack of history of this new financial instrument. The BPO has already been granted the status of acceptable collateral by banks, and can be used to secure a financial facility. Much in the same way, the features and advantages of the BPO must be appropriately communicated to those in positions of influence and authority, to assure appropriate regulatory oversight of BPO transactions.

The success and sustainability of the Bank Payment Obligation will require decisive, proactive and ongoing engagement and championing by industry leaders, both at the conceptual and market positioning level. Few today would dispute the potential of the Bank Payment Obligation: the challenge, and the opportunity, lies in assuring full engagement in the development and deployment of the BPO as a transformational solution in trade and supply chain finance.
“With the ICC soon to give the BPO international recognition by formally approving new Uniform Rules for BPO in April 2013 and promoting this new payment term widely amongst the import-export community, the BPO will enable banks to de-risk international trade and automate a range of supply chain finance processes: offering suppliers payment assurance and easier access to various pre and post shipment finance models, while allowing buyers to extend credit terms at the same time as supporting their supply chains. This new payment term has high potential to fuel global trade and enable economic growth, especially if banking regulators allocate capital rules to reflect the low default rate of BPO’s closely related trade instrument, the LC.”

Source: SWIFT Interviews, Marcus Hughes, Director Business Development, Bottomline Technologies
LOOKING AHEAD

The business of international trade has enjoyed – and will continue to enjoy for the foreseeable future – a great deal of profile among business and political leaders, and as a direct result of this focus, there is now a widespread realisation around the fundamental role of trade finance in supporting and enabling global commerce.

Even as trade flows shift, trade corridors change, expand or contract, and the classical distinctions between import, export and foreign investment fade in favour of a more integrated and holistic view of international commerce, the role and profile of trade finance has been brought sharply into focus, and will not soon fade to the background again.

The advantages of such profile include both the opportunity and the responsibility of leaders in trade finance, to communicate and to champion the value proposition of trade finance, and to leverage this profile to secure support, investment and resources to help advance the capabilities and options related to the four core aspects of trade and supply chain finance: payment, financing, risk mitigation and information.

The business of trade finance involves commercial activity with very attractive qualities, including negligible loan loss history (which some argue is indicative of excessive caution), consistent returns, and attractive opportunities for corporates and for banks, to leverage trade and trade finance as a means of developing additional business and additional, high-value, relationships. Under current conditions, the engagement in “real economy” activities linked to the flow of goods and the creation of economic value remains compelling.

Trade finance has once again begun to attract the attention of non-bank providers, particularly in the context of supply chain finance and in relation to the needs of SME’s; this trend will continue, and several providers will carve out attractive and profitable niche positions in the market, perhaps motivating financial institutions to consider additional delivery channels for trade finance, and perhaps also driving further development and innovation through new models such as the BPO.

The role of export credit agencies and IFI’s will continue to be central to trade finance, likely increasing in importance over the medium term as the focus of economic growth and trade activity shifts to Asia and to the next group of high-growth economies, and as ongoing pockets of crisis continue to motivate disciplined focus on effective risk mitigation. Propositions such as the BPO will seek to ensure the ability to incorporate the participation of international agencies, public and private sector risk mitigation specialists and other contributors to the business of trade and supply chain finance, guided by corporate demands for bank and technology-agnostic solutions.

Relatedly, the ongoing hope for a global standard of structured communication will continue to figure prominently on the wish-list of those most closely engaged in the technical and transactional activities linked to trade finance.
Platform-based e-invoicing options with accelerated settlement capabilities, and with financing options, will continue to appear in the market, and as businesses gain confidence in such platforms, these entities will present competitive threats or opportunities for strategic alliance and extension of channels, to traditional providers of trade finance.

The impact of mobile technology and its link to settlement options and financing mechanisms will grow exponentially in the coming two to three years, both in domestic and international commercial transactions, with the effect that propositions such as the BPO will need to consider the incorporation of mobile and “App”-based capabilities.

Regulatory pressures will continue to impact the ability and willingness of banks to undertake international activities, and to allocate scarce capital to relatively secure but lower-return activities such as traditional trade finance. Industry efforts to influence regulatory requirements around trade finance will continue to demand significant resource commitment, both in terms of advocacy and in terms of data-gathering and analytics, also likely motivating new propositions in the trade space (if they involve banks subject to regulation) to allow for adequate data collection and dissemination.

The focus on SME’s is likely to continue to gain traction, both in the political and in the banking/commercial environments, including in the context of international supply chain finance, with the effect that the BPO and other transformational business models will wish to ensure their relevance and applicability to this important bank client segment and this equally important political constituency.

Trade and supply chain finance will continue to evolve, at a pace and in directions perhaps unaccustomed in an industry that has used the same traditional instruments over a period of hundreds of years: the energy of change and innovation has arrived in trade finance, and its effects, though still moderate in practical terms, cannot be reversed.
CONCLUSION

As with most significant new developments, the BPO benefits from the vision and engagement of early adopters, in this case leaders in business and banking, while remaining impacted by a tendency by some to favour the status quo. The BPO represents both an incremental and prudent evolution of the traditional trade finance model, drawing on key lessons from the past, and a potentially transformational option which seeks to provide importers and exporters with the flexibility, robustness and security of the L/C, combined with the efficiency and elegant simplicity of the open account transaction.

The clear link between the BPO and a market requirement (from banks and corporates), and the inclusive, partnership-based approach to the development, ongoing refinement and deployment of the BPO lend credence to the wide-ranging adoption of this new instrument of trade finance, and suggest strongly that the BPO is not only a welcome addition to the trade finance toolkit, but also a clear and sustainable evolution of the business model and value proposition related to trade and supply chain finance.

The Bank Payment Obligation presents a compelling opportunity, both as an instrument of twenty-first century trade finance, and as an illustration of a broadly collaborative effort in the design, development and deployment of a transformational business solution. The focus now must be on accelerating adoption, and on assuring commercial viability of the Bank Payment Obligation, and in both those respects, broad engagement from across the industry will be critical to success.