



*The
Bank Payment
Obligation:
a new payment term
to secure and finance
trade*

A new start for Supply Chain Finance

In Q2 2013, the banking industry releases a unique set of legal and technology standards to unlock the real potential of the Supply Chain Finance market. These standards enable banks to provide their corporate clients with Supply Chain Finance services as from the very start of trade transactions, i.e. when the sale contract is signed. This innovation extends the scope of Supply Chain Finance to risk mitigation and to pre-shipment finance services. It also offers local banks and development banks an opportunity to increase their role in supporting a vital segment of the economy: the SME market.

Key benefits for corporates

- Working Capital and Cash Flow Improvements
- Easier Access to risk mitigation, pre-shipment and post-shipment finance
- Increased automation of payment, reconciliation and forecasting processes
- Win-win relationships between buyers and suppliers

Key benefits for banks

- Reduced costs thanks to digital process
- Shortened transaction time thanks to accelerated data matching
- New transactional revenue and increased customer satisfaction
- Focus on core competencies

Industry standards are a critical foundation for any competitive eco-system

Faced with increasing pressure to meet short term liquidity needs, companies are looking inward for ways to release trapped cash from operations. Today's CFOs and treasurers are taking a fresh look at how their physical supply chain is impacting their companies' cash flow and working capital management.

Supply Chain Finance (SCF) aims to improve the financial efficiency of the supply chain and substantially reduce the working capital of both buyers and suppliers. It allows buyers to extend payment terms while providing suppliers access to better financing rates. It creates a true win-win for all the parties involved as one of the most attractive tools for companies to diversify funding sources, enrich and solidify the relationships with their trade partners.

For decades, technology has been impacting our lives on a daily basis. In order to maximise the benefits, various industries have identified the need to define standardised ways to structure data and facilitate efficient exchange of information between counterparties. Also called "industry standards", these technical and business protocols have been as critical as the role of language in communication between people.

Over the last 40 years, industry standards have proven to be an essential foundation for many industries including financial services. Firstly, standards provide end-customers with a baseline to compare commercial offerings. Secondly, they facilitate competition between commercial offerings whilst enabling them to interoperate.

Competitors are naturally reluctant to interoperate given their short-term commercial goals and their preference to lock customers in their fully proprietary solutions. In emerging industries, commercial players therefore often try to postpone the interoperability discussion. However, agreement on common interoperability rules and standards is proven to develop the total size of an industry. Interoperability should therefore be considered as a key milestone for an industry to grow to the next level of maturity. A good example is the Global System for Mobile Communications (GSM) standard which is embedded in our mobile phones and interlinks the mobile phone operators across 212 countries. Thanks to this standard, a GSM mobile phone user can reach any person in a network of more than 5 billion people.

A key aspect when setting up industry standards is the need for such definitions to be owned by non-commercial industry organisations and to be available in the public domain. In financial services, 40 years ago, banks decided to create a cooperative standardisation body to take up this role and SWIFT was born. Today, SWIFT's standards cover a wide range of financial services such as payments, foreign exchange, trade and securities in both the bank-to-bank and corporate-to-bank segments.

SWIFT's standards provide major interoperability benefits to all parties involved in financial transactions, including corporate clients. SWIFT's standards are used by close to 10,000 institutions in more than 210 countries.

In supply chain finance, banks have also decided to develop new legal and technology standards to address interoperability challenges and to grow the size of this emerging market.

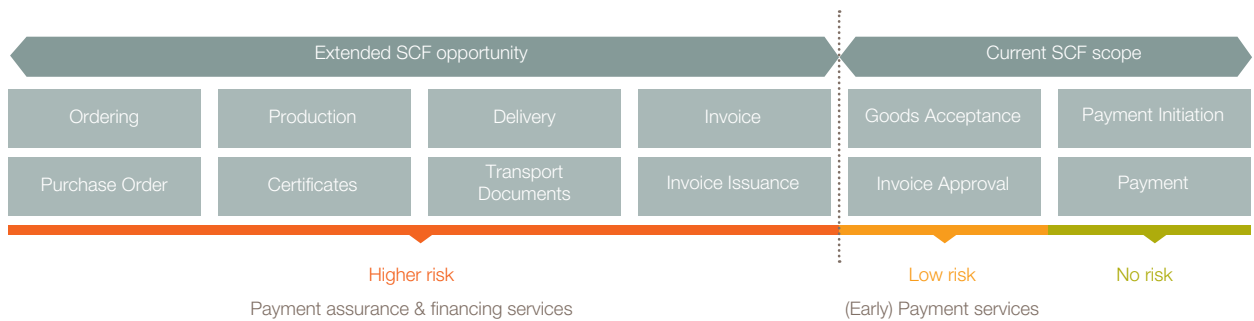


Figure 1 - This figure shows the current scope of SCF services which are triggered very late in the transaction lifecycle, that is, once the invoice has been approved whereas the customers' needs start as soon as the Purchase Order is agreed, that is, when the supply chain starts.

Supply Chain Finance: today's offerings start at the end of supply chains

The supply chain finance (SCF) market – the term used by banks to refer to approved payables financing or early payment services – has grown significantly over the last five years. Such services have demonstrated their relevance and value to large buyers and their suppliers. The now widely available SCF offerings offered by banks and non-bank technology providers have been built on the fact that buyers and sellers wish to work in a win-win spirit as large buyers aim to support their suppliers' working capital needs. Typically buyers facilitate early payments to their suppliers via one of their banking partners. Buyers therefore approve invoices as early as possible in the process in order to maximise the financing opportunity for suppliers in need of working capital. Such services have also validated the fact that banks are ready to extend financing to their clients using electronic and automated transaction flows as they do in payments and cash management services since more than 20 years.

Supply Chain Finance: today's offerings are reaching their limits

The progress made by banks in this market has not been without challenges. Most of the services have been developed independently by each bank and do not make use of any common foundations. Typical drawbacks reported by practitioners can be summarised as follows:

- **Late start.** Approved payables financing services begin at the penultimate stage of trade transactions when the invoices are approved whereas the corporates' needs for financing and mitigating risk start much earlier, i.e., when the Purchase Order is raised. The real opportunity for banks is to get involved as early as possible in the transaction cycle Limited to large buyers. Today's SCF offerings are rolled out as buyer-specific programmes and mainly address the large buyers whereas the real SCF opportunity extends to large sellers too, in particular in terms of payment assurance
- **Supplier on-boarding raises costs.** Current offerings require in most cases the buyer's counterparties - the suppliers - to be enlisted on the buyer's bank portal. The multitude of SCF platforms generates operational issues for suppliers wishing to benefit from various SCF offerings via their buyers' banks.

Ideally, suppliers would be served by their chosen – often local – banking partner, not by their buyers' banking partners

- **Know-Your-Customer (KYC) costs.** Most banks require KYC checks to be performed on such suppliers being enlisted as new customers, which is increasing the total processing cost and putting the business case for the bank at risk
- **Proprietary formats.** Today's offerings make use of proprietary formats which makes it more complex and costly for corporate clients to integrate in their internal applications (e.g., ERPs) whereas all players want to benefit from end-to-end automation to limit processing costs
- **Lack of standardised product definitions.** The naming and definitions of the various SCF services vary from one bank to the other which makes it difficult for clients to compare offerings and consider switching from one provider to another. The industry has, however, started to address this issue and delivered global SCF definitions via the BAFT-IFTA organisation.

Despite the above shortcomings, the SCF market has grown, but it did so without relying on strong foundations. The market is beginning to face some difficulties due to the absence of interoperability standards. This is why banks have decided to develop specific ICC and SWIFT standards for this market.

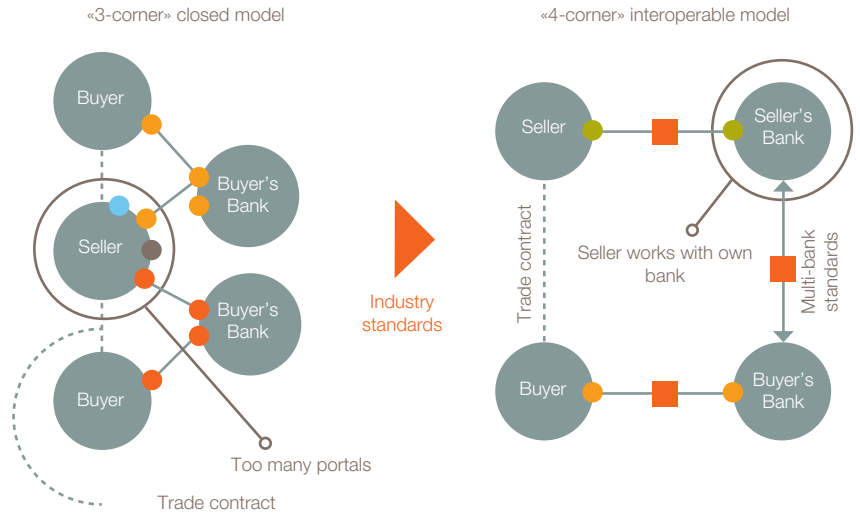
Industry standards will help banks grow the size of the SCF market

Given the limitations of the current SCF set-ups, banks have developed new legal and operational standards that will help bring the market to new levels both in market size and in product scope. By introducing such standards, banks aim to move the market from the 3-corner (or single-bank closed model) to the 4-corner model (or two-bank interoperable model). Banks also intend to extend their offerings beyond the current early payment services. Here is how:

➤ Involving the supplier's bank.

Moving from the typical 3-corner to the 4-corner model will allow large banks to extend their SCF services by involving local banks. The 4-corner model will enable correspondent banks to reach out to a larger number of suppliers, usually the SMEs. This needs to be done by relying on local banks which can best assess SMEs' performance risks. It will also eliminate the need for the buyers' banks to on-board suppliers, as well as the related KYC costs as the two-bank model relies on the relationship between the supplier and its own bank.

➤ **Early start.** By providing SCF offerings at the very beginning of the transaction, banks will be able to address requirements such as the provision of pre-shipment finance which is required as soon as the Purchase Order is agreed. They will also be in a position to provide payment assurance, which is critical for any seller at the very early stage of the transaction. Extending the payables financing services will also be possible, well before the approval of the invoice.



▲ Figure 2 - This figure illustrates the current problems faced by suppliers who need to join various banks' platforms, as well as the more positive situation where their own (local) banks are involved.

Issues with the "3-corner" closed model	Benefits with the "4-corner" interoperable model
✗ SCF services limited to approved payables finance and target large buyers	✓ SCF extended to pre/post-shipment finance and payment assurance, and should target large sellers too
✗ Seller needs to connect to various SCF portals operated by its buyers' banks	✓ Buyer and seller work with their preferred banks; no unnecessary on-boarding of seller by buyer's bank
✗ Buyer's bank faces additional supplier on-boarding and KYC costs	✓ Seller's bank takes risk on buyer's bank, not on buyer
✗ Proprietary formats increase costs for all and limit end-to-end automation	✓ Multi-bank industry standards facilitate technology independence between all parties and end-to-end automation
✗ Lack of common legal and operational foundations limit adoption	✓ Standards accelerate adoption as initial investment is re-usable with many banks

▲ Figure 3 - This figure compares the main issues of the 3-corner model to the benefits of the 4-corner model.

Corporates need more than Approved Payables Financing

In Q2 2013, the International Chamber of Commerce (ICC) and SWIFT roll out new industry-owned legal rules and technology standards for supply chain finance. These standards enable banks to interoperate through their correspondent banking agreements in order to provide risk mitigation and pre/post-shipment financing in the 4-corner model. The combination of legally binding rules with electronic messaging and matching provides unique efficiency benefits not yet witnessed in the trade industry to date.

Known as the Bank Payment Obligation (BPO), the new trade settlement instrument offers buyers and suppliers (irrespective of size, geography and industry) a new payment method to secure and finance their trade transactions. The BPO is easy to use by corporate clients as it is offered as a new payment term next to existing ones (e.g., letter of credit, advanced payment, open account payment) as documented in the ICC Model International Sale Contract.

Banks will extend their correspondent banking relationships to URBPO

In order to offer BPO-based services, banks need to implement the inter-bank Uniform Rules for BPO (URBPO) as well as the underlying messaging standards. This is facilitated by SWIFT's ISO 20022-compliant inter-bank messaging and transaction matching cloud application called Trade Services Utility. For banks, the BPO is also convenient to use as it integrates into the correspondent banking agreements that banks have in place for international payment and trade transactions.

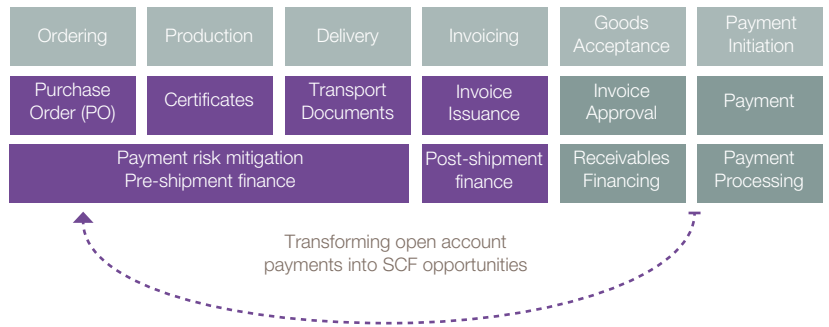


Figure 4 - This figure shows that the Bank Payment Obligation and the underlying ISO 20022 standards enable banks to extend their SCF offerings to higher value services.

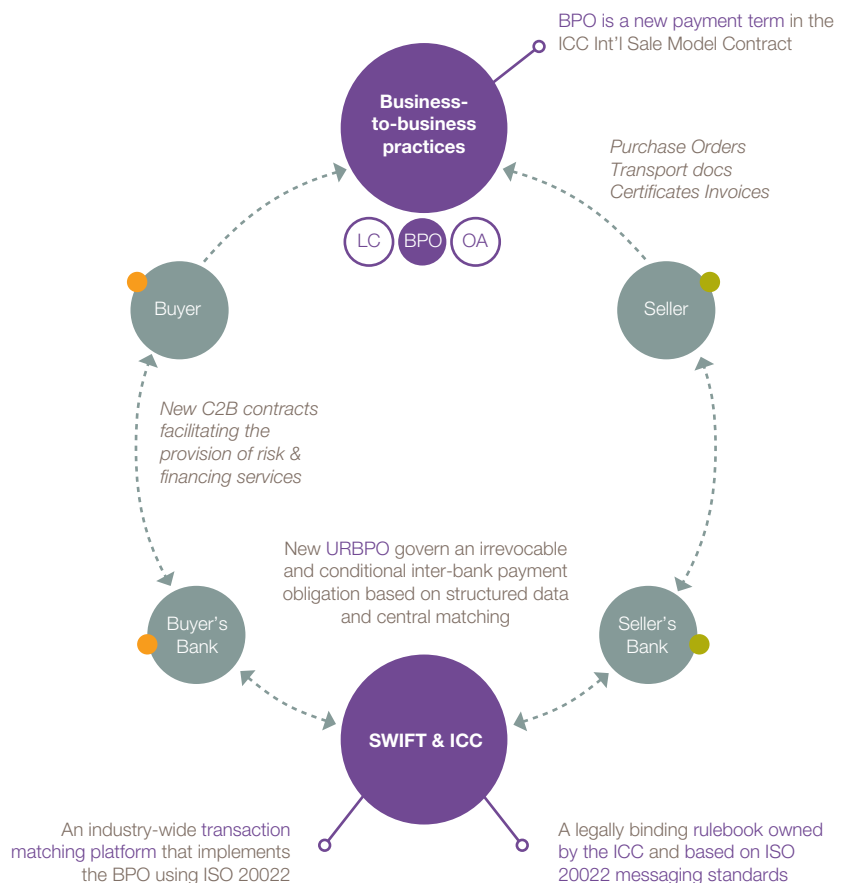


Figure 5 - This figure shows how the BPO fits into the two-bank model and re-uses the correspondent banking practices so that corporates can benefit from the BPO with their chosen banks.

Development Banks have an opportunity to extend their roles too

Given the intended global use of the BPO and the high demand for pre-shipment finance from SMEs in emerging markets, the involvement of multi-lateral development banks (MDBs) in BPO transactions will be critical in some geographies. As the BPO shares features similar to those of the letter of credit (i.e., both commercial banks have full visibility on transaction details and BPOs are self-liquidating transactions), MDBs have the opportunity to extend their role on BPO transactions. Typically, BPOs issued by buyers' banks can be secured by MDBs using techniques similar to those established for letters of credit, i.e., by issuing guarantees on BPO transactions issued by the BPO obligor bank, which is usually the buyer's bank.

"Multi-lateral development banks aim to support local banks as well as the SME market", explains Steven Beck, Head of Trade Finance at Asian Development Bank (ADB) and Member of the ICC Banking Advisory Board and of the WTO Working Groups for Trade Finance. He adds:

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 "The new BPO trade settlement instrument is an efficient way to extend export financing to SMEs in Asia and we trust this new mechanism will contribute to increasing support to this vital segment of the economy".

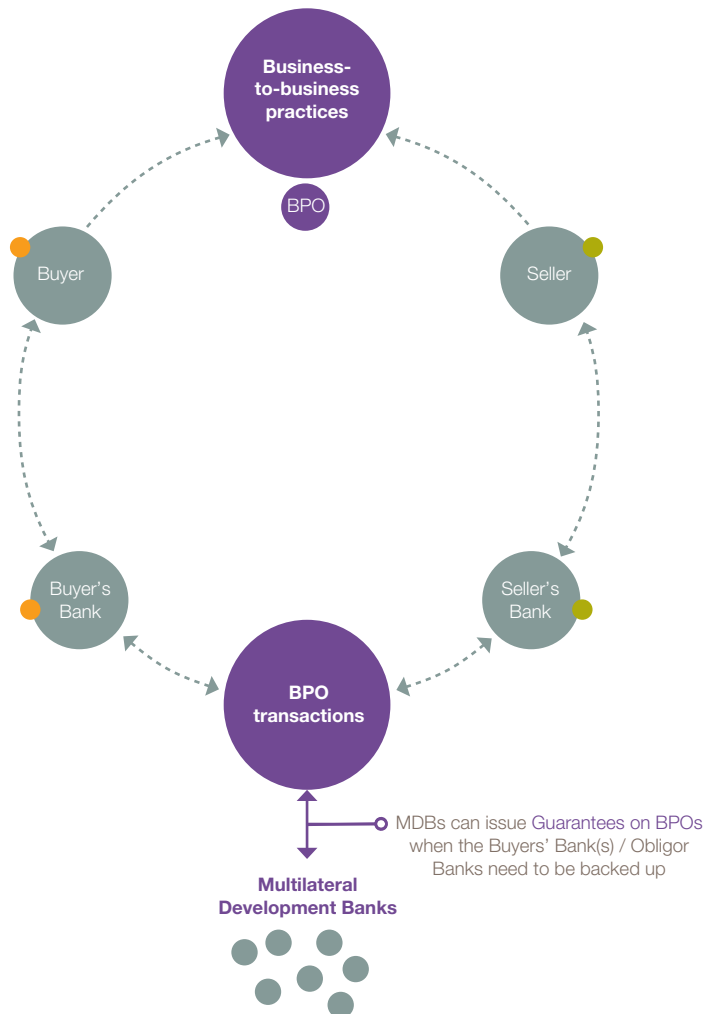


Figure 6 - This figure depicts how MDBs can get involved in BPO transactions.

Conclusion: moving open account payments to the trade finance space

For decades, trade bankers have demonstrated that working collaboratively and leveraging the appropriate standardisation bodies (such as ICC and SWIFT), can effectively address their clients' requirements and help them develop their business. Trade banks have developed the BPO instrument and the related ISO 20022 standards in order to efficiently support the further development of international trade in a modern way. By defining legal and technology standards, banks aim to better respond to their corporate clients' desire to accelerate financial processes and optimise their working capital as well that of their most critical counterparties.

The industry has attempted to dematerialise trade several times since the 90s and many initiatives have not delivered as expected (initial Bolero vision, e-UCP rules and initial e-Bill of lading initiatives). The first BPO implementations completed by the 5 live BPO banks over the last 18 months suggest that this innovation will help the trade industry address the supply chain challenge. Bank of Tokyo Mitsubishi UFJ, Bank of China, Standard Chartered Bank, Korean Exchange Bank and Siam Commercial Bank are actively attracting corporates to benefit from the BPO.

At Sibos in Osaka, Karen Fawcett, Group Head of Transaction Banking at Standard Chartered Bank put it very clearly in an interview with Trade Finance magazine:

.....
"As we get the BPO online, we are going to pick up what was just a payment, an unfinanced and uninsured instrument, and move it into the trade finance space, thereby growing the trade finance business remit".
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David Vermylen, Global Credit Manager for BP Chemicals - the first large exporter to use the BPO - illustrated the benefits of the BPO in a recent interview published in The Corporate Treasurer:

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"Before the BPO, BP could physically move 150,000 cubic meters of LNG [liquefied natural gas] faster than it could process 500 grams of paper. Things needed to change".
.....

Yumiko Hoshino, Executive Officer, Overseas Department at Ito-Yokado, the Seven & I Holdings Group superstore operator which is the first importer to use the BPO, explained how the new instrument would be an integral part of doing business in Asia:

.....
"Exporters want faster payment and less paper, so our suppliers who are using this love it".
.....

Ito-Yokado has benefited from the BPO for over a year thanks to leadership of Bank of Tokyo Mitsubishi UFJ. Shigeki Kawabata, General Manager, Transaction Banking Division, Bank of Tokyo-Mitsubishi UFJ, who has been an advocate of the BPO from the outset agreed:

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"Leadership will be a significant success factor to drive change and we are happy to be first on the Asian market with the BPO".
.....

It seems that getting ready on the BPO sooner than later is a wise choice for trade bankers.

Next step: getting ready on the new ICC and SWIFT SCF standards

The time has now come for the banking community as a whole to prepare for this innovation. Banks now have the opportunity to extend their supply chain finance services from invoice-based processing services (e.g. factoring and early payment services) to purchase order-based services, such as payment assurance, pre-shipment and post-shipment finance. By promoting the BPO payment term to trading counterparties, banks will accelerate the financial supply chain and become better financial partners.

Dan Taylor, Vice-Chair of the ICC Banking Commission and Managing Director at J.P.Morgan confirms the rationale for ICC and SWIFT to work together: "Combining the ICC rules and arbitration role with SWIFT's correspondent banking network and matching technologies offers the required legal and technology foundations for banks to secure and finance open account trade transactions in a standardised multi-bank environment".

As Kah Chye Tan, Chair of the ICC Banking Commission and Global Head of Trade and Working Capital at Barclays said at Sibos during the now traditional Monday morning ICC Supply Chain Finance briefing:

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"This is a golden age for trade finance. All banks wish to better engage in open account transactions and the BPO will make it happen".
.....

A total of 50 banking groups have understood the opportunity that comes with the BPO and confirmed their decision to extend this innovation to their corporate customers. As corporates discover the benefits of the BPO, they will expect their banking partners to react quickly.

André Casterman

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and Introduction to the Bank Payment Obligation",
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