BANK PAYMENT OBLIGATIONS
A NEW METHOD TO TRADE

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Introduction

Financial messaging service provider SWIFT and the Banking Commission of ICC have jointly introduced Bank Payment Obligations (BPO), an innovative bank assisted trade instrument a potential game-changing innovation shaping supply chain finance and international trade in coming years. Their objective is to enable a favorable international trade growth outlook and to build confidence among international traders. BPO could change the way that companies manage their global supply chains, making it easier and safer to work with new suppliers in risky markets. But acceptance takes time. The Uniform Rules for BPO released by the International Chamber of Commerce will undoubtedly boost their use.

Bypassing the tedious document management and exchange process involved in a traditional LC with a much faster and easier alternative, BPOs have the potential to change the world of trade finance by effectively acting as an automated letter of credit, Although BPO is not expected to replace open-account trade finance arrangements, which provide a direct connection between a buyer and its supplier, It would make it easier to enact trade in risky markets and set up new supplier lines and may change trade relationships between buyers and suppliers with a shorter history of working together,

The traditional methods of payment were; Payment in Advance, Documentary Credit, Documents against Payment, Documents against Acceptance and Open Account. Today over 84% of global trading is carried out on Open Account terms. However, payment under Documentary Credit continues to be a popular method in the Asian region. In emerging and developing countries the smaller banks have been coming to the fore as providers of trade finance to the small and medium sized enterprises and helped to slow the decrease of Documentary Credit business in those regions.

New challenges

There has been a significant shift away from the use of traditional trade instruments such as letters of credit, in favour of trading on open account with the ever growing volume and value of international trade, As a result of the crisis of confidence in credit markets, new challenges have emerged forcing the implementation of a more restrictive regulatory regime.

Advances in new technology, has intensified the market demand for new solutions to help deal with increasing cost pressures, to identify ways of optimising the management of working capital and enhancing process and to apply rigorous measures to the management of risk but owing to the changing risk dynamics.

The world trade has changed dramatically during the past decade. Widespread liberalisation in emerging markets has resulted in Borders and barriers being broken down. The combined pressures of globalization and the internet have accelerated consolidation and specialisation, at the same time encouraging a wave of new entrants among service providers. Industry forecasts indicate that world trade will grow by 73% in the next 15 years, with merchandise trade volumes in 2025 hitting $48.5trillion, compared to today's $27.2trillion. ICC and SWIFT were best positioned to help the banking industry facilitate further growth of trade using innovative solutions.

As the volume and value of international trade has grown, there has been a significant shift away from the use of traditional trade instruments such as letters of credit, in favour of trading on open account. Driven by advances in new technology, the market has demanded new solutions to help deal with increasing cost pressures, to identify ways of optimising the management of working capital and enhancing process and to apply rigorous measures to the management of risk but owing to the changing risk dynamics.

Straight Through Processing (STP)

It was in the late 1990s that SWIFT introduced the concept of Straight Through Processing for interbank transactions. The standardization SWIFT demanded helped to build a uniform system globally thus enabling the member banks to benefit from fully automated processing of SWIFT transactions thereby reducing the ever increasing operating costs which more than compensated for the investment the banks had to make in doing the necessary modifications to their software systems.

In the case of trade transactions it was necessary to go beyond interbank transactions by including the commercial parties like the buyers, sellers, insurers and transport operators. It was with this in mind SWIFT joined hands with Bolero in 1998 to develop an open platform for paperless trading between buyers, sellers, logistics, banks, agencies and customs anywhere in the world. This venture was supported by over 20 major banks handling trade finance and the system was made operational for a limited number of transactions. However SWIFT was only a business partner of Bolero and were not a part of the business decisions making process of that company. One major mistake that Bolero made was to make substantial increases in their charges for the entry and the use of the system thinking that they were in a monopolistic situation. The result was that they were not only able to attract any new customers but they forced even the existing users to go back to traditional processing methods which made the company struggle to make ends meet.

Knowing the potential and the market demand, SWIFT was once again eager to develop their own open platform. There were few offers from existing service providers including Bolero to use their platforms since they have already been developed for that purpose. Thus SWIFT, building on the system developed by Bolero started with an application which they called the Trade Services Utility (TSU) which was supported by a number of the major trade finance banks. However, SWIFT made sure that they had some control over the decision making authority of the company to avoid suffering from the same fate as earlier. One of the major deficiencies of the TSU which was in operation was that it had no provision for handling the payments. It was to overcome this deficiency and to help the banks to automate their supply chain financing function that SWIFT took the further step to develop the Bank Payment Obligation and also make it available not only to the TSU but any equivalent platform developed for the same purpose using the global standard ISO 20022 messages.

SWIFT's Trade Services Utility (TSU) offers the required interbank messaging and matching utility for banks to handle their customers' BPO transactions. The agreement paved the way for banks to use the SWIFT BPO rules as an automated alternative to traditional letters of credit for settling a trade transaction.

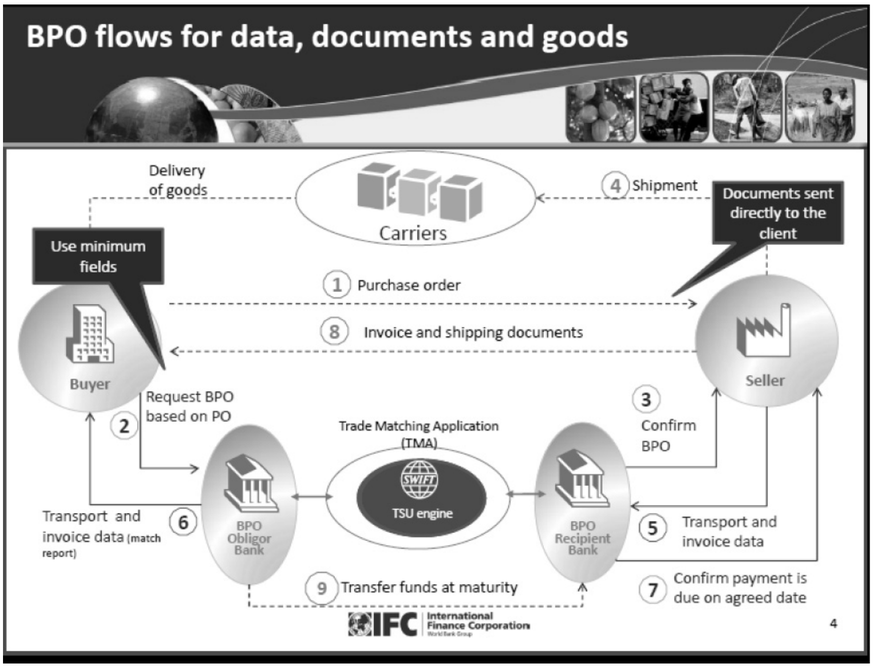
Bank Payment Obligation

Trade finance is a critical banking service supporting the world economy. It is vital that the industry aligns on enhanced rules and tools in support of trading counterparties whether large or small. BPO is a new solution in supply chain finance to shape trade in the 21st Century, an alternative means of settlement in international trade providing the benefits of a letter of credit in an automated and secured environment

BPO, as defined by financial messaging service provider SWIFT and the Banking Commission of ICC is an irrevocable undertaking given by one bank to another bank that payment will be made on a specified date after successful electronic matching of data, generated by SWIFT's Trade Services Utility (TSU) or any equivalent Transaction Matching Application, based on Uniform Rules for BPO issued by ICC. Essentially, BPO is an alternate payment instrument to settle international trade with automated processing and reduced risk.

The BPO will provide the benefits of a letter of credit in an automated environment, without the drawbacks of manual processing associated with traditional trade finance. It will also enable banks to offer flexible risk mitigation and financing services across the supply chain to their corporate customers.

BPOs enable banks to mitigate the risks associated with international trade to the benefit of both buyers and sellers. They enable flexible financing propositions across the supply chain, from pre-shipment to post-shipment. They provide an assurance of payment to the seller similar to that obtained under a confirmed letter of credit. BPO will combine the best of both worlds (Documentary Credit and Open Account) and will offer an alternative means of settlement in international trade.



Source: IFC - International Finance Corporation (World Bank Group)

SWIFT ICC collaboration

SWIFT (Society for Worldwide Interbank Financial Telecommunication) is a financial messaging provider for more than 10,100 financial institutions and corporations in 210 countries. The total number of financial messages sent via SWIFT for the year 2012 was 4.589 trillion and in 2013 up to end of August was 3.342 trillion growing at almost 9.6% The average daily traffic for the year 2012 was almost 18.1 trillion in 2012 and in 2013 up to end of August was almost 19.9 trillion growing at around. 9.6%. SWIFT is committed to helping its member banks deliver innovation in trade finance to the corporate world.

The ICC was established in 1919 to ease the flow of international trade. For decades now the Documentary Credit has become established as universal market practice, thanks largely to the publication and maintenance by the In International Chamber of Commerce (ICC) of a set of rules, the Uniform Customs & Practice (UCP). These rules governing letters-of-credit practices were first introduced in 1933 as UCP 100. The universal acceptance of the UCP by practitioners in countries with widely divergent economic and judicial systems is testament to its success. UCP600, is the latest revision now in use around the world. Banks need the BPO standard rules to secure their customers' international receivables, the BPO rules developed in consultation with ICC's network of National Committees in about 70 countries and carrying the ICC seal of approval will undoubtedly ease the way for small and midsize companies to use this new trade instrument.

Both ICC and SWIFT believed that by working together and leveraging their respective positions across the trade finance community, they can ensure that the BPO will have an important role to play in supporting the development of international trade in the 21st century, addressing cost pressures in the face of increased automation and changes in the regulatory environment. They joined forces to develop and adopt an industry-wide standard by producing a set of rules on Bank Payment Obligation (BPO) which will help more participants to this product.

What BPO can offer

The BPO delivers equivalent business benefits to those previously obtained through a commercial Letter of Credit, while eliminating the drawbacks of manual processing associated with traditional trade finance by having automated and secure processing. One of the key features of the BPO is that it supports interoperability between participating banks, because it makes use of a standard set of ISO 20022 messages. This interoperability enables banks to collaborate with one another to extend reach across global markets, in order to provide a comprehensive range of supply chain services to corporate customers. The matching of data using ISO 20022 messages reflects events that have taken place in the physical supply chain, which create trigger points for the provision of financial supply chain services – for example, a proposition for pre-shipment finance based upon a confirmed purchase order, or a proposition of post-shipment finance based upon an approved invoice. The BPO may be used as collateral in each case. The industry has also collaborated with corporate users on the extension of the ISO 20022 messages exchanged between financial service providers, so that those same messages can be adapted for communications between corporates and their banks. These messages will, for example, enable end-to-end straight through processing with corporate ERP systems.

L/C v BPO

In the case of traditional trade finance instruments like Letter of Credit (LC), the undertaking on irrevocable payment is between the banks and their corporate clients, whereas a BPO is an irrevocable payment undertaking between the buyer's bank and the seller's bank. Therefore in BPO situations you will not find a confirming bank. Traditional trade finance processing and matching are paper based, manual, time consuming and expensive; whereas BPO processing is automated by providing for electronic processing and matching using the global standard ISO 20022 messages. While a LC guarantees exchange of goods for payment based on physical presentation of compliant documentation, a BPO guarantees exchange of goods for payment based on electronic presentation of compliant data. Traditional trade finance instruments are characterized by high cost due to manual processing, frequent discrepancy handling and liquidity pressures. On the other hand, a BPO's automated processing and matching reduces the processing cost and enables banks to offer competitive rate to corporate for the BPO transaction. Timely delivery of matching reports on POs and invoices enables corporates to have quicker access to liquid resources.

BPO v L/C using eUCP

The letter of credit and the BPO represent two alternative methods of payment. Where a letter of credit allows the presentation of electronic records the related terms of payment will be governed by eUCP as a supplement to UCP. If a BPO is used, the related terms of payment will be governed by the URBPO. In this case, the proposition is enhanced by the automated matching of data.

Fees and charges under BPO

The banks will set their own tariffs when charging the corporate customer. Those charges will vary from bank to bank. Fees paid to the Obligor Bank would typically reflect the transaction processing costs of managing data input / exchange with the Transaction Matching Application (TMA) as well as a risk premium for the buyer based upon their credit worthiness. The Recipient Bank would charge fees for transaction processing costs of managing data input/ exchange with the TMA on behalf of the seller and possibly, a risk premium associated with the credit worthiness of the Obligor Bank if the Recipient Bank is offering some form of risk mitigation to the exporter.

One would expect that the use of a Transaction Matching Application would reduce the transaction processing costs compared to L/C fees. Risk fees are expected to be at the same rate as for an L/C but may be charged for a shorter period as a BPO can be added at any point in the trade cycle, so exposure duration is likely to be shorter than with an L/C

ICC's Uniform Rules for BPO

ICC's URBPO are the first-ever Uniform Rules for Bank Payment Obligations (BPOs), a 21st century standard in supply chain finance that governs Bank Payment Obligations transactions worldwide. BPOs enable banks to mitigate the risks associated with international trade to the benefit of both buyers and sellers. They enable flexible financing propositions across the supply chain, from pre-shipment to post-shipment.

The ICC Banking Commission has developed the Uniform Rules for Bank Payment Obligations, ICC Pubication No.750E in partnership with financial messaging provider SWIFT to take into account the legitimate expectations of all relevant sectors. Bankers, traders, lawyers and all trade practitioners who deal with BPO will refer to these rules on a daily basis. It contains 16 articles and follows the usual pattern adopted by the ICC Banking commission in formulating rules.

Multiple Benefits of BPO

BPO provides many benefits to exporters, importers as well as banks by mitigating risks in international trade for buyers and sellers alike. Speed, reliability, convenience, reduced costs, improved accuracy, enhanced risk management, assurance of payment, access to flexible financing and securing the supply chain are some of the other benefits

Exporters stand to derive many benefits from BPOs. It provides assurance of payment with the credit risk being transferred from the buyer to the Obligor bank and thereby giving access to flexible pre-shipment or post-shipment finance from banks. It reduces risk of buyer cancelling or changing the order and the buyer cannot refuse to pay due to a complaint about the goods. By using a BPO issued in the currency of the seller's country the foreign exchange risk can be eliminated. The seller can structure the delivery schedule according to the seller's interests, determining when payment will be made and shipping the goods accordingly. The bank bears responsibility for any oversights and automated data matching reduces complexity and increases reliability. The risk of discrepancy, dispute and delay is reduced by removing the subjectivity of physical document-checking. BPO can be introduced at any stage of the transaction. Mismatches can be accepted and automated processing accelerates settlement and financing

Importers too stand to benefit from BPOs. It is safer than payment in advance. The buyer does not have to pay up front before receiving the documents of title to the goods purchased. It facilitates financing for the buyer e.g. extended payables. It strengthens buyer/seller relationships and secures the supply chain. It helps to expand business opportunities and may increase the buyer's competitiveness in foreign markets. The buyer can confirm that the goods are shipped on or before the due date to the required specification and can structure payment according to the buyer's interests, the buyer can negotiate for better terms and conditions. By issuing a BPO, the buyer demonstrates the ability to pay and can negotiate for improved terms for any future transactions. The BPO protects the buyer since the bank only pays when the seller complies with the specific terms and conditions and produces the data required. The buyer can build safeguards into the BPO, including inspection of the goods and quality control, and set production and delivery times. The main advantage is that it increases convenience and reduces costs.

Banks too stand to benefit from BPOs. It offers low risk business, prudent use of capital and a steady source of commission and fee income. BPOs open the door to new business opportunities and helps strengthens core relationships. It is an automated solution thereby lowering operating costs and meets the market requirement for banks to collaborate more on risk in taking on new clients. Banks can also offer value-added services like financing, cash-forecasting, liquidity and working capital management to their corporate clients based on underlying trade transactions and reporting. Large banks also has an opportunity to offer white label processing tools for the banks that would not like to build their own BPO processing tool.

Open account often fails to provide banks with access to underlying transaction data thereby impeding their ability to follow relevant events in the physical supply chain. The BPO and related ISO 20022 messaging standards provide additional clarity and transparency by providing access to relevant data, records and reporting, giving banks the ability to provide risk mitigation, finance and payment services while introducing additional automation and efficiency into the supply chain management process. By matching data via the ISO 20022 messaging standards, banks can track events in the physical supply chain which help to trigger the availability of value-added services in the financial supply chain. Unlike the manual checking of documents, there is no subjectivity attached to data matching – it either matches, or it doesn't.

Since there is no manual processing like document creation, verification, validation, tracking and reporting, BPO will benefit corporates operationally It will also result in significant cost savings for the corporate through early access to pre-shipment finance and post-shipment finance needs. It facilitates risk mitigation as the undertaking is between buyer and a seller bank. There is no need to reissue the document in case the shipment happens at a different location, due to external factors such as natural disasters. Corporates will not have to incur bank charges on discrepant document handling and tracking and there will not be any any verification and amendment charges. For the exporters it will also facilitate early liquidity and working capital management due to faster transaction processing and settlement. The importers can access the goods early, as they will receive the documents quickly.

Participating in BPO

A bank interested in becoming a participant member immediately for BPO (Bank Payment Obligations), it must first register with the SWIFT Trade Services Utility (TSU). The bank can register on-line via www.swift.com .The registration fee varies according to the global tier of the bank. Once registered, SWIFT will assist the bank to go live. With ICC Approval of URBPO, other services providing Transaction Matching Applications, similar to the TSU, are eligible to support BPO transactions.

The operational savings one could expect from enrolling in the TSU or similar Transaction Matching Application will include first a reduction in the expense of document examination. Secondly, there will be a reduction in the number of discrepancies thanks to an improvement in the matching rate that can be achieved by electronic data presentation. By reducing the number of discrepancies, banks and corporates will be able to reduce the investigation effort, avoiding disputes, delays etc. The impact will vary from business to business.

Weaknesses of BPO

Banks that are willing to offer BPO services need to invest in technology infrastructure/ system capable of supporting and communicating with the Transaction Matching Application as well as ISO20022 compliant messages. If not they may not be able to provide BPO services to their clients.

Banks may shy away from coming on board due to the difficulty in making a business case based on potential demand. On the other hand not having the capability when corporate customers need it may result in the bank losing a valuable customer to a competitor who has the capability to provide the facility

It is a new solution in the market with a limited transaction history track record and therefore material marketing effort is needed to increase transaction volume and BPO acceptance. Full STP requires integration and process change on the customer side as well incurring additional costs. BPO has a transactional approach and does not deal with portfolio

In certain countries the physical trade documents may be required under local legislation of those countries to release the delivery of goods from Customs. This may not be a legal issue in Sri Lanka but the government authorities concerned such as the Customs, Ports Authority etc. may have to adapt to the changing environment.

Also from a legal perspective, there may be certain issues that need to be looked into.. A key issue is how the law in the relevant jurisdictions will treat and enforce a BPO. For example, who has legal standing to sue to enforce a BPO? What damages are available from an obligor bank for its failure to pay its BPO? What is the applicable time period during which a legal action to enforce a BPO must be commenced against the obligor? What defenses (besides the failure of data to match the pre-established baseline) may be validly asserted by the obligor to its obligation to pay a BPO?

Capital and accounting treatment of BPO

ICC has presented their recomendation for the Accounting & Capital Treatment of BPO and it is important to edhere International Financial Reporting Stands. Based on the initial reference of ICC Banking Commission, the BPO has the characteristics and behavior of a contingent liability and at the time of issuance; this would be an off-balance sheet item for the Obligor bank and characterized as unfunded.

The execution of a BPO is contingent upon agreed transaction terms between the Obligor and Recipient Bank. The BPO, once utilized, will be removed or liquidated from the books and balances of the Obligor and the Recipient bank upon the execution of a BPO for a payment "at sight". It will be on-balance sheet item if the deferred payment undertaking changes into a definitive undertaking at the time of dataset match by the Transaction Matching Application.

The BPO should not be treated as a Guarantee (or Standby Letter of Credit), be it performance related or a payment guarantee, or others. The main differences are that the execution of a Guarantee is triggered by a non-performance or a default in a (trade) transaction. The execution of a BPO is triggered by a performance, being the shipment of the underlying goods as evidenced through a (successful) data matching process, which is a completely different situation. The BPO is part of the trade cycle itself. One party delivers, and the other party pays by means of a BPO. This is not the case with a Guarantee.

The Probability of Default (PD) is purely counterparty-driven, and is dependent from the financial status of the obligor. Therefore, the PD of a BPO issued by order of a specific party should not be different from other engagements or liabilities undertaken with the same specific party as obligor. The PD is dependent from the rating (internal or external) the bank has assigned to the obligor.

In principle, Loss Given Default (LGD) is product driven. Since there is no reliable track record available for the BPO, banks involved in issuing or receiving BPOs will be subject to what the Basle Rules call "Internal Ratings Based Foundation". In this regime, the LGD is determined by the rules, and is set at a fixed 45%. It is possible that, after some time, banks will shift to the "Internal Ratings Based Advanced approach. This change will require banks to demonstrate a credible track record, or develop an expert model, approved by their regulator, to determine their own LGD. As said earlier, this is, for the time being, not possible for the BPO.

Accordingly, ICC propose to set the LGD for issuing a BPO or for "confirming" a BPO at the predefined value of 45%. Since this is an Off balance Sheet Undertaking (OBU), for the calculation of the Risk Weighted Asset, a Credit Conversion Factor (CCF) of 20% should be used for commitments with an original maturity up to one year and 50% for commitments with an original maturity over one year. These levels are recommended, based upon current Basel guidelines as they apply to other off balance sheet undertakings such as documentary letters of credit.

Since October 2010, the Basel rules allow the Effective Maturity of a letter of credit transaction to be used with a minimum of one day, instead of the effective maturity with a minimum of one year. Given that the BPO has the same objective and character as a letter of credit, this waiver of the one year maturity floor should be applied to the BPO as well. Credit Conversion Factor applies to the calculation of the Leverage Ratio. Under Basel III, all OBUs are subject to a CCF of 100% for the calculation of the Leverage Ratio.

This means that these off balance sheet items will be considered as on balance sheet items for 100% to calculate the Leverage Ratio. The industry feels that this is unjust as far as letters of credit are concerned, since these off balance items cannot turn into on-balance sheet items because of an event of default or other events beyond control of the banks, but only by the presentation of conforming documents relating to the underlying sale of goods or services. Therefore the Industry, ICC and other bodies are advocating to bring down this CCF for letters of credit to 20%. It is self-evident that BPOs should be under the same regime if this CCF for of 20% is granted to letters of credit.

Given the lack of historical data and commercial experience around a new instrument such as the BPO, the current discussion related to capital adequacy is framed almost entirely with reference to recent experience around traditional trade products. Early engagement of the Basel Committee and national regulators, as well as other parties in a position to influence the application of capital rules to the BPO will be a key element of the ICC s and the industry's approach going forward.

Conclusion

The present government is planning to develop Sri Lanka, inter-alia, as a Commercial Hub. The pre-requisites for any Hub are the physical infrastructure, the digital infrastructure, the legal infrastructure and the human resource infrastructure. In considering the availability of the infrastructure requirements for BPO, there does not appear to be any major constraints to its implementation in Sri Lanka.

Sri Lanka Customs embarked on an automation project 'e-Customs' and has been making some progress. Some of the leading shipping companies have the capability to issue e-bills of lading but the required infrastructure is still not available to make full use of it. The Lanka Gate e-Services project was launched by the Information and Communication Technology Agency (ICTA) with the main objective to deliver e-Services to the general public through a common portal via service portlets, adopting a Virtual Business Transformational approach. However their priorities appear to be developing selected on-line services to government institutions and they do not posses sufficient human resources at their disposal to engage in a massive trade project. The ability to use SWIFT' TSU and a TMA operating in an overseas location can be used to overcome these shortcommings and take Sri Lanka to being a commercial hub by offering the latest technologically developed solutions.

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