BANKS MUST MOVE TO THE NEXT LEVEL OF THE GLOBAL TRADE FINANCING WITH BPO

Why need a move?

Trade Finance and Trade are the life blood of not only Asia but of any other continent and key drivers of growth and employments. It would be in the interest of Asia as a region and Sri Lanka as a country aspiring to be the" wonder of Asia" to implement the reforms that insulate trade from further disruption. However as an unintended consequence; the new reforms could potentially add regulatory cost and access barriers to trade as per the critics who comment on BASAL iii document which very affirmatively states if no preventive measures are taken, trade finance could dry up with a another financial crisis similar to that of 2008.

In view of the above situation, it is my opinion as well as many others in the trade financing business, the way forward should leverage primarily on technology and e-commerce that can reduce cost and deliver greater efficiency, enhance information flow, transparency and security.

The Global merchandise trade that stands at USD27trillion is expected to grow up to USD43trillion within next 11 years according to a recent survey conducted by HSBC. It further states that 87% of world trade is presently conducted on open account trade pattern. That also implies 87% of Global Trade is conducted with no direct financing from the banking industry and exporters are taking brunt of the risks. What do these figures reveal? They reveal that plenty of opportunities are available for banks to finance provided the banks are willing to be part and parcel of the supply chain embracing the technologies that can reduce cost, deliver greater efficiencies, information flows and transparency that can provide security to clients engaging in cross border supplying and banks providing supply chain finance.

Impact of Asian Developments

The other important feature revealed in HSBC survey is that a number of Asian Countries namely China India, Egypt, Vietnam, Indonesia and South American countries like Brazil are set to take the lead in the economic development expected within next 10 years of which China is going to be the major power house in the region. Sri Lanka being a country that has built up a relationship with China over centuries and has actively got China participated in almost all the major developments in the recent past and the ongoing projects too should stand a better opportunity to further strengthen its relationship through trade related activities during the next decade or more. However in the context of the present scenario, it appears that the current ruling party is not very much in favour of continuing the relationship built up by the last regime. This is something in my opinion the new leaders should rethink before jumping into conclusion in view of Chinas future position as the Global Leader in Trade.

Chinese President Xi, in his address to Asia Pacific Economic Cooperation (APEC) summit recently concluded; has declared that China will make investments outside to the value of 1.24 Trillion within next five years and import commodities to the value of USD10trillion during the next 10 years. These revelations cannot be ignored by any person who looks for opportunities to develop trade in the next decade. However, to remain active as a participant in this race all involved parties have to be equipped with technologically advanced products backed by service standards.

Banks' Participation in Supply Chain Finance

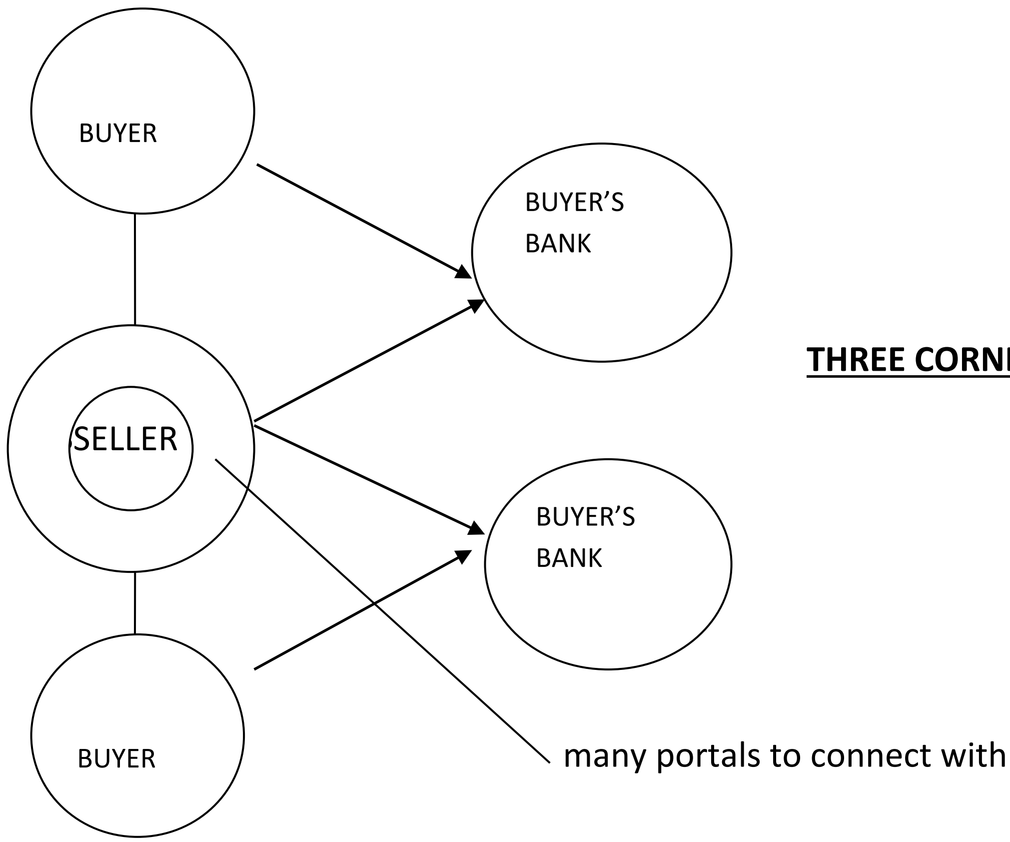
In the above anticipated scenario what is clearly visible is that corporates are well ahead in comparison to the banks. They have developed the supply chain even without much support from the financial institutions and are able continue the trend in any given scenario to meet the future demand. However the Banks appear to be not equipped with the technology that required toeing in line with modern supply chain concept. This is particularly so in the context of commercial banks in Sri Lanka. Their shelves are full with traditional trade products like documentary credits, standby letters of credit, guarantees and documentary bills.

There are no other value-added products to offer the discerning traders who want to move to the next level in the global trade. This was the major drawback for banks to participate in supply chain management as envisaged by corporate bodies dealing with modern supply chain process.

Expanding Supply Chain to the next level

On the other hand the most practiced supply chain model at present is the “Three Corner Supply Chain” model with the buyer’s bank in the centre. This model lacks the convenience and adequate access to finances except for a very few corporates dealing with reputed buyers having relationships with banks of good standings. The bills payable by their reputed buyers with maturities are available in the buyers’ banks portals enabling selected sellers to either discount or forfeit them on stipulated terms, or for other banks willing to take buyer’s bank risks. They are known as approved payables. In today’s context taking sellers on board and advancing them is more risky than providing them with credit facilities in view of KYC and other related regulations. Thus the availability of finance to lesser known parties in the supply chain; especially for SMEs are unbelievably out of reach. Apart from the constrains mentioned above, it is also costly for a seller to interoperate with a buyer’s bank in a foreign country most often due to system incompatibility or inability to communicate on account of various technical or other reasons with ERP (Enterprise Resource Planning) of the seller’s company.

The shortcomings observed above too would have had an impact on the supply chain finance for its expansion to a greater extent. In this scenario even among the corporate; only a limited number of companies had the opportunity of engaging in supply chain management and carry out their business in the style of open account trade. At the same time it has come to light in a survey carried out by ADB that there are many SMEs who engage themselves in open account business, because of their inability to substantiate with documents necessary for their own assessments in order to obtain bank facilities. In the estimate of ADB, they account for 80 to 90 percent of Asian business population of which 15 percent are exporters. In the post global crisis period we have observed Multilateral Development Banks coming to the rescue of this segment through various funding programmes. In 2012 alone ADB has funded to the tune of USD4billion benefiting 1577 SMEs including SME'S in Sri Lanka through commercial banks under their Trade Financing Program.



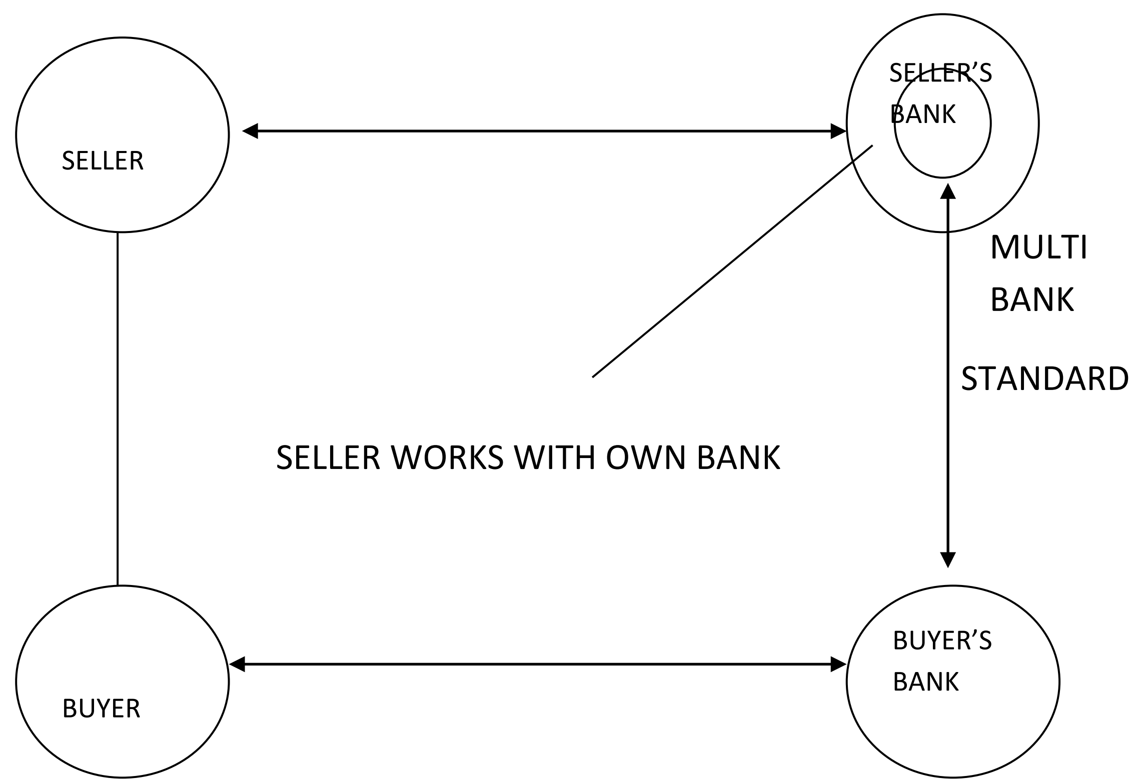
THREE CORNER MODEL

Four Corner Supply Chain Model

Having taken into account the drawbacks observed in the Three Corner Supply Chain model as illustrated above and also the potential advantages of developing same in to a four corner model enabling buyers and sellers to engage in a seamless trade transaction reducing cost, improving delivery efficiencies, information flow and security, SWIFT initiated designing a Four Corner Model with built in international standards regulated by International Chamber of Commerce Paris. These regulations are known as Uniform Rules for Bank Payment

Obligations (URBPO). The rules came into effect from 1 July 2013 with its publication No. 750.

FOUR CORNER MODEL



What is the Four Corner Supply Chain Financing Model backed by ICC rules?

This is similar to the work module followed by letters of credit to guarantee the settlement part of an underlying contract. In a contract where payment is assured via an Irrevocable Letter of credit, the buyer arranges to open a letter of credit through the bank he deals with; in favour of the supplier or the seller in a foreign country. Similarly in a modern open account transaction where payment is assured through an irrevocable bank payment obligation (BPO) the buyer arranges his bank to issue a Bank Payment Obligation not in favour of his supplier but in favour of his supplier's bank. This is conceptually a huge step forward from the traditional L/C concept where an undertaking hitherto given to a seller or a supplier by a bank; transforming to a **bank to bank agreement** eliminating a need for a third bank to step in as a confirming bank as in the case of letters of credit. It is going to be a huge cost savings if the parties involved are dealing with reputed banks. At this stage the first two corners of the Four Corner Model are occupied by the buyer and the buyer's bank.

The next two corners of the model would obviously be occupied by the seller and the seller's bank. However unlike in the case of L/C transaction where seller's bank comes to the picture after the shipment mainly to obtain settlement, whereas in a BPO transaction seller's bank comes to the scene immediately after signing the purchase order. In a BPO transaction seller has to nominate his bank as the recipient bank to receive settlement. Therefore the seller's bank has to play a very vital role in a BPO transaction if it agrees to participate as a recipient bank. This arrangement under BPO would further eliminate the need to look up to seller for recourse in the event of non payment by the obligor bank. That is because; Buyers and sellers submission of data to their respective banks in respect of their underlying contract do not fall under the ambit of BPO. Therefore any arrangement to present data to banks by buyers or sellers is considered an act in a competitive stage outside BPO; which also is not subject to URBPO (Uniform Rules for Banks Payment Obligations). This provides banks to be competitive and also more flexible when designing front end of the customer space of a BPO transaction.

Establishment of Baseline

Initially the buyer presents the details with regard to the purchase contract that he had entered into with the seller; to his bank which is also known as the **obligor bank.** In this information the settlement part of the transaction agreed between the buyer and the seller would be; buyer's bank payment obligation to the seller's bank which can be either on immediate payment or deferred payment against matching of data with the established baseline; presented to TMA via the seller's bank. The seller too present similar details with regard to the sales contract with the buyer. Both the buyer's bank and the sellers bank submits contract details to an agreed Transaction Matching Application (TMA) which is a Claude based trade service utility as branded by SWIFT. Once the TMA matches the details with zero mismatches and notify both banks accordingly; it establishes the baseline for the underlying transaction and after which BPO becomes irrevocable undertaking of the obligor bank. The submission process of contract details for establishment of a baseline by the involved banks to a TMA comes under the collaborative stage. In this stage both banks have to present the details to TMA via XML in the ISO20022 format. Any notifications or reports sent to the involved banks also would be in the same format and it is a prerequisite that all involved banks should make use of ISO20022 Trade Service Management (TSMT) format when communicating with TMA in respect of BPO subject to URBPO .

Data Set Match Report

Once the Baseline is established the next stage would be for the seller to ship the goods according to the contract and forward the documents such as Bill of Lading, Invoice and Insurance ect. to the buyer direct enabling him to clear the cargo as in the case of normal open account trade. In the meantime the seller has to submit data according to the baseline agreed; to his bank for onward transmission to the buyer's bank or the obligor bank via TMA. If the data submitted tallies with the baseline, TMA would send Data match report to all involved banks compelling the obligor bank to settle the transaction as per the baseline agreed. In case the data presented to a TMA is rejected due to mismatches a report to that effect also would be sent by TMA immediately. On the other hand if the mismatches are accepted by the obligor bank on the instigation of the buyer a mismatch acceptance notification also would be sent to the all involved banks by TMA and thereafter the BPO once again become effective for settlement. The important characteristic of BPO is that the banks need not maintain huge international departments with so many staff as there is absolutely no necessity to manually intervene and examine documents as in the case of L/Cs since the documents are sent direct to the buyer. As mentioned in the preceding paragraphs, BPO does not deal with documents at any stage and all match or mismatch reports are generated and advised automatically by TMA. Hence it is less time consuming and the banks should be able save more times for their core businesses.

Conclusion

In my opinion now the banks have a better trade financing product namely BPO that should ideally meet the needs of supply chain today. Can the Banks move forward to the next level of the global trade without BPO? A Billion Dollar question worth considering if our commercial banks are still interested in making Sri Lanka a USD150Billion economy by 2020 and wonder of Asia.

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