

# Standardised trust

Better future for Trade Finance, February 2017

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## **We just have to do something!**

Risk management and financing of trade, especially, the foreign trade has always been complex. Traditionally Trade Finance has been a means for trade parties to utilise the integrity of banking system to ensure the safety of transactions. Trade and its different practices have been there for centuries and the trials to make the process fluent and simple by electronic means have been only partial improvements. There have been many attempts to digitize the known existing process only addressing some parts of the complexity. At the same time the payments or merely the Cash Management domain has been successfully deployed the new Financial Services standard, ISO 20022, not only in Europe but in many other parts of the globe and the expansion continues.

This challenge has been discussed for years by a small Reform Club type of constellation in Finland of dedicated bankers and corporate treasurers. We've seen the SWIFT Trade Services Utility for Bank Payment Obligation – BPO - development, positively fully ISO 20022 based, but it has not redeemed its promise to standardize trade related payments. Currently many large corporations are moving to use the only universal tool SWIFT MT798, that wraps the old fluffy MT700-series messages into an envelope for message exchange between the corporations and their banks. This solution has inherited all the defects that the misuse of MT700-series messages has had. ISO 20022, with the facilitation of SWIFT, has also developed ISO 20022 messages for Guarantees and Standby Letter of Credit, but their use do not practically exist as the main instrument support (Letter of Credit) is missing.

International Chamber of Commerce (the ICC) has also made an attempt to unify the market practice between different global players by publishing its rule books and interpretations of different Trade Finance instrument use cases. In cooperation with banks they have developed the eUCP rules for electronic part of the Trade Finance but still the global Trade Finance community participants do not always feel ICC to have the latest edge on its work.

In February 2017 the Finnish Trade Finance Reform Club decided to arrange a 24 hour, dedicated boot-camp to address these challenges in April 2017. The team gathered onto an island in Sipoo, nearby Helsinki with an idea to create ourselves a solid improved foundation for future Trade Finance.

The solution search was decided to be done with a coaching methodology called GROW.

The method is based on four stages:



G=Goals, R=Reality,  
O=Obstacles/Options and W=Way  
Forward.

We first decided on the common goals for the better Trade Finance. Then we listed the reality pain-points i.e. why we are not already now at our goal? The third step was to analyse these reality pain-points and what of those are actual obstacles and then, if there are any available options, to tackle them. The final stage was to discuss

and agree the most feasible ways forward.

Each step was evaluated and brainstormed in small and efficient groups and then presented to and consolidated within the whole group. This way each new step had a common approach to dig into deeper stage. All the expert resources were allocated to the commonly decided focus point with the result introduced in this white paper.

### Goals – vision of the future Trade Finance

The Reform Club listed two main goals to strive for: Economy of Trust and Standardised Trade Finance.



The current Trade Finance instruments are to ensure the financial flow for the trade between the trade parties, the Seller and Buyer. The use of instruments can be based on the lack of trust between the trade parties e.g. regarding the payment, delivery of goods/services or any other performance under the commercial contract. Trade is always embedded with risk. There is a risk not to succeed in the actual supply chain, quality and timing of the agreed delivery or finally getting the compensation of the delivered goods or services. The risks are related to the actual trade counterparties, resellers and other supply chain, logistics, authorities, countries and politics just some to list. Higher the risk level, more mitigation means are needed. These mitigations are coming with a price tag. But in the end

the Buyer wants to buy goods and services from the Seller under certain terms and price. That should be ensured in a way that these two parties would be able to do it with the lowest cost and by trusting each other.

Economy of Trust can be reached by building up a common global and permissioned credit & rating registry or platform of Trade counter-parties, including banks, and added with country and political risk rating. This is really nothing new and there are already solutions and some service providers for this on the market. The challenge is that the services are fragmented with separate focus areas, solutions are not easily interoperable and reliable payment behaviour rating service is missing, just a few to mention. A common and robust registry for political and country rating is also missing. In the ideal case both the Seller and Buyer could easily check the necessary prerequisites for the trade transaction. This type of service would be especially valuable when trade parties don't know each other and first commercial transaction is being negotiated. However, also when the trusted supply chain partnerships needs periodical review such a registry would support and speed up the process. Making this type of service available also for SMEs, would enhance the common trade basement as in many times the biggest global welfare potential is related to well-functioning small enterprise segment in the economy.

With the Standardised Trade Finance the team defined following areas for more structured approach:

- processes
- documents
- platforms.

With these three areas there are very obvious opportunities to improve. When the overall processing of the Trade Finance transactions is done in a common and well-defined way, the parties may rely more on the counter-parties needed to complete the transaction. Having matching processes will reduce the need for case-by-case speculations and focus could be instead on the practical trade. Trade document, mostly paper based, complex structures is one the biggest hurdles in the Trade Finance automation and improvements. We also live in the world of frauds and forgery when dealing with paper documents. Trade documents must be electronic with a common semantic model that enables their contents use in various automation and Straight Through Processing tasks. Otherwise other listed elements are not feasible. Finally the existing trade platforms are not solving all or even majority of the challenges listed. They are not easily interoperable and accessible for needed parties and other possible stakeholders. The platform technologies are usually based on legacy and centralised structures where the platform authority has a key role setting the platform terms and conditions of its use. New emerging technologies, like Distributed Ledger Technologies or Blockchain are seen as promising option for better transparency due to distributed databases, atomic transactions that are irreversible and that they are based on computational logic and consensus.

## Reality bites with the pain-points



This part proved to be the most challenging to keep focused and condensed. It generated a vivid discussion and a large amount of practical defects affecting the current capability to tackle the whole Trade Finance management both at corporations and banks. This is a clear signal that there is definitely a high urge to start doing something as the current status is simply painful.

The Know Your Customer – KYC – process where the regulated requirement to pose same identification and due diligence documents for multiple Financial Institutions that have still different interpretations of the requirements is felt really tedious. Periodical KYC reviews multiply the agony. There is absolutely no exchange of this data and rating of KYC

between the financial institutions and corporations see this simply frustrating and a sign of mistrust.

Trade parties' payment behaviour plays a key role in the reliability of rating. This type of information service is not offered in practice at least on regional or global basis. The current rating agencies have their own focus and mostly have rating on large corporations only. Even if the exported transaction might be sizeable, the Buyer may be a SME and there is no way for the Seller to know if the SME has ability to pay or if they pay in time. Respectively the SME as a Buyer has no resources to check if the Seller has been rated with its performance, delivery and goods & services quality.

The fragmented nature of such registries, platforms and service providers results a situation where a trade transaction stakeholder analysis takes time, is costly and still not 100% reliable or sufficient. Since the data received from the service providers is not in an analysed format it needs further refinement by the party ordering the analysis. This could lead to risky decisions and result in costly risk mitigation solutions or even ignoring the final risk. By this we mean that some Trade Finance instruments have in-built capability to speculate the final undertaking to pay and at minimum could cause a delay in payment by interpreting the ICC rules. We also can't ignore the fact that in some parts of the world there are companies thriving from these interpretations (education, extra fees, frauds etc.)

There is no proper standardisation drive in Trade Finance because of its long history and fragmented market and banking practices. The most common statements in Trade Finance are: "We have always done it like this, and will continue to do so" or "Buyer doesn't accept anything else". Challenging the "status quo" in order to move towards to standardised processes, products, documentation and platforms is needed. As discussed already in the background, SWIFT's messaging tools have not been able to

solve in full fledged way the electronic communication between the trade parties and the financing banks.

Good example of this unstructured approach is the MT700-series tag 47A – Additional Conditions. That far the message parties have been able quite well structure the terms of the Trade Finance instrument but the 47A could, if wrongly used, demolish the structure and even overrule what has been previously stated. The Reform Club's opinion was to get rid of it as soon as possible. Yet, it is known that the further SWIFT-community's development of MT700-message series is leading to opposite direction, which is a pity and makes us think if SWIFT is actually motivated to equip us towards eUCP or ISO 20022 standardised Letter of Credit?

ICC is expected to give good guidelines in the rules standardisation area for the Trade Finance community. It is crucial that the technical standards as well as the market practice stakeholders have possibility and fora to collaborate. ICC should involve more end-user corporations and platform & application vendors into the collaboration. Historically, ICC has focused more on different interpretation of ICC rules and how those rules should be read and interpreted when examining different documents. These interpretations could be even taken to the Local courts, when the reason behind is usually not the Trade Finance instrument or documents but dispute between trade parties and finding a reason not to pay. And of course we need to keep in mind that the local country-specific legislation cannot be overruled by the ICC rules. The latest developments luckily show that ICC has started to raise its profile and has started a task force on setting minimum standards for electronic Trade Finance and utilisation of the new technological solutions. And for example ICC Finland has become active in gathering persons regularly to discuss about digital future of trade finance both from banking community as well as exporters.

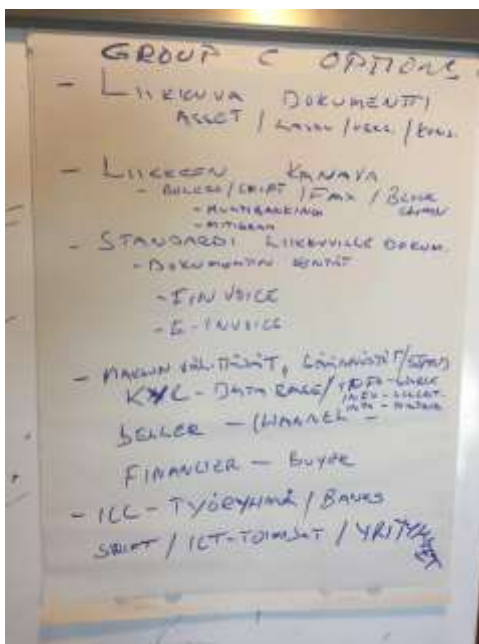
We identified earlier the need for high level of expertise on this business area. As the processes are ancient, paper-based and full of exceptions, there is not that much interest by new entrants. The existing specialists are getting older and if in short term new technological solutions will attract new people into this area, the problems will expand. This lack of expertise has partially resulted Open Account use as the complex Letter of Credit is avoided even the risks are then higher on the final payment executions by the trade delivery terms. Letter of Credit is misused as trade guarantee purpose instead of its original use case of ensuring the payment execution according to simple trade documents and their terms.

Various Trade Finance related platforms and service providers available are fragmented and non-interoperable. They are not reasonably accessible by the smaller companies and therefore cannot solve the community goals. The banks also have to decide on which large corporations platforms they participate as each of them require separate integration as the messaging and integration technologies vary per platform. The only practical format, SWIFT MT798 and its MT700-series message use is available for very large corporations only due to the requirement of the SWIFT Corporate access (SCORE). This is something that SWIFT and MT798 supporting banks could think about in order to speed up the increase of MT798 corporate-to-bank traffic volume.

Trade documents are not standardised in layout or in contents, even there has been discussions about electronic Bill of Lading over a decade. Documents' transformation to pictures or pdfs is not a solution. Trade Finance instrument attached and supporting documents are mainly on paper and this is a basis of inefficiency. The contents of the documents cannot be electronically analysed and therefore the visual inspection is the only option. Review is done by humans and again the interpretations of rules are not self-explanatory but lead in many times to long disputes by the trade parties and financial institutions.

### Obstacles and how to tackle them

The Reform Club had a long philosophical discussion on the two main goals, Economy of Trust and Standardised Trade Finance and if one is needed before the other? This means the classic hen or egg problem. After the debate we reached a consensus that both must be gone for in parallel as they support and boost the other.



The Economy of Trust obstacle could be settled with a platform development, both in Trade Finance co-operation and in technical development. This does not mean one and only platform but platform basement that would make various competitive platforms interoperable and accessible for stakeholders being members in the different platforms.

As earlier discussed the current platforms are vendor or authority specific and the transparency and accessibility for all, especially smaller players, is not always the best possible. Distributed Ledger Technology and Blockchain based initiatives and Proof of Concepts show special opportunities and therefore a need for common and real market practice work and collaboration is clear. Going into various

technical DLT platforms is not a solution and their interoperability with a common semantic Trade Finance data model must be guaranteed by smooth stakeholder collaboration. Already defined ISO 20022 business model as well as European Public Procurement eInvoice semantic model may serve as a good basement for further Trade Finance instrument and process development in dedicated market practice groups. The Reform Club thought that this can be started in small scale (amount of stakeholders and geographical markets like Nordics or EU) to get first steps established as Minimum Viable Products and then expand it gradually on solid and, structured base. In many cases the end-users' voice, Seller and Buyer, is not heard properly in this type of collaboration and that should be improved as well as trade corporations own process development to be aligned with the upcoming platform requirements.

The future platform should be supported by electronic, structured and accessible documents that can be set with basic smart contract rules to trigger the next steps' execution in the supply chain. When the payment undertaking is undisputable and documents are available and immutable the risk management and financing is easier without high level of speculation or manual work. Stakeholder specific open documents at a common platform would enable new business models as risk taking as a commodity. Common documentation templates enable also process harmonisation at the both final trade parties and supporting financial institutions.

Regulation on Know Your Customer and its harmonisation should be also part of the platform as authorities are important stakeholders. With the new technology and available documentation and reliable electronic identity (person, role and organisation) the trade party rating would be also more reliable. If there is any feasible way to include the discussed and needed reliable payment behaviour rating, should also be challenged.

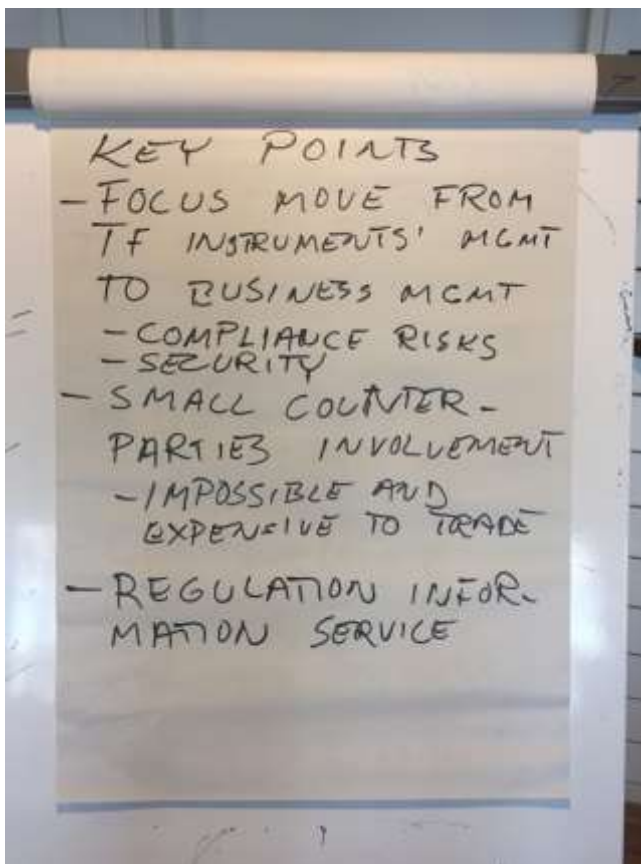
The standardisation challenges should also be solved in common market practice groups consisting of key stakeholders. This could mean a creation of simple check list for complex Letter of Credit cases of roles and responsibilities/undertakings in each case type. ICC has had a key role in coordinating and developing this, but not always succeeding. However, when the new technical opportunities for irreversible transaction actions are arising, ICC could also raise its profile and demand a creation of a new technical task force with immediate effect. We should keep in mind that e.g. a Letter of Credit is a payment method and nothing else. At the same it is considered as separate conditional undertaking to pay and therefore the way forward could be clearing the base case: it is not an agreement with different interpretations but a simple instrument steering the fixed terms and conditions on trade payment execution and financing.

We have been used to call some Trade Finance instruments as Documentary Payments, but should we not challenge, right now, if we still need papers in Trade Finance, in future. Most of these challenges could be solved by smart contracts, standardised and fewer documents on simplified cases having a common semantic information model. These tools would enable modern vendors to create technical tools on electronic document management. At the same time the document contents would be available for business intelligence and even artificial intelligence operations to get more behaviour and market practice information on existing trade cases. On the platform implementations based on common semantic business model repository it will be possible to exchange and analyse information which is currently scattered to various stakeholders' legacy systems. This would create a positive circle and iteration to create common market practice rules based on electronic Trade Finance and get rid of paper based one. The recommendable common language in cross-border trade should be English in order to guarantee common treatment and interpretation. Local languages could still be used locally and in local trade but always having English equivalence. Even this sounds obvious, the Reform Club identifies a big challenge implementing this language proposal.



## Way forward and collection of recommendations

The trade focus should be transformed from Trade Finance instrument management to business management. This also applies to new technological tools and their modelling. Common, as simple as possible, business model should be established on based level before technical Proof of Concepts. With this the digitalisation can truly start on rethought basis, since just trying to technically optimise the defected current status quo of processes and instruments will not take us to the desired goal. When business and financial processes align it would be easy to focus on creation of supporting technical models and platforms.



If being able to create a new, interoperable platform model based on standardised Trade Finance instruments, documents and practices, the creation of new supporting business models would follow automatically. This on itself would lead the development from complexity to simplicity. By using more or completely standardised Trade Finance instruments the Seller and the Buyer can leave the remaining complex cases freely available for competition as these cases could be accessed by different service providers. The Reform Club large corporations were really interested to consider this type of full fledge service as out-sourced while they could focus on their actual business and delivery of their high quality products and services. This type of full fledge out-sourced service

could serve in all complexities like regulation, financing and payment terms, document management. When the platform will make many current unknown items known, the transparency automatically creates efficiency and cost-savings. At the same time each stakeholder will be able to train their trade management related personnel aware of common practices instead of multitude of exceptions currently. This will make the sales and purchase for key trade parties much easier and would also tempt new expert entrants into this business area suffering of diminishing expertise.

The current development of technical tools' has been mentioned many times previously in this discussion paper. Distributed Ledger Technology or Blockchain by nature are building up trust and transparency when not based on single authorities or legacy solutions. Accessing the new suggested platforms by Application Programming

Interface – API – technique will also enable new business models when the trade data and business logic will be programmable and available for further use. Smart Contracts are seen as a key element on the new trade documentation management on a computational basis. When the documents and processes will be based on common semantic models the standard encodings of these will be available for bigger technological audience of service providers making the business models more attractive and feasible to build and execute.

Key findings can be summarised into a table below

Trade Finance outlook	Economy of Trust	Standardised Trade Finance	Future tools/means to be experimented
Processes/Means	Current processes are based on lack of trust and the risk of counter-parties covered by instruments. Regulatory burden given to parties and not equipped with suitable means (for example KYC)	Swift messages MT7xx, MT798, ISO 20022 (without actual L/C message) - Risk mitigation results to deteriorations of instruments/messages	Distributed Ledger Technology, Blockchain
Platforms	Swift channel, Bolero, Global Trade etc.	Multiple platforms not easily communicating with each other	Cloud-services, multiple smoothly communicating network. Value/ownership transfer by intelligent means, Blockchain etc.
Documents/Assets	Trasferable standard documents, invoices, drafts, Bill of Lading; Authentication by manual signing on paper documents. Various and delimited focus market places for the assets, risk sharing and trading.	ISO 20022 standard, European Public Procurement e-Invoice, but no common semantic model for Trade Finance.	Smart Contacts, value transfer in an intelligent channel / platform. Trade Finance semantic business model and standard repository for platform and information exchange development.

The collaboration by definition is requiring all stakeholders' activity. Answers for the past, current and future challenges cannot be achieved by one stakeholder sector only. The Reform Club is suggesting creation of a new small team with capability and willingness to expand when the first critical steps and key principles are firstly commonly agreed. This could start from Finland or Nordics and inviting some of the key stakeholders into the action. The story will soon continue!

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