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Position Paper on Drafting ICC Rules for Supply Chain Finance

1. Introduction

To satisfy the market demands of trade finance practitioners and standardize Supply Chain Finance ("SCF") practice globally, the Global Supply Chain Finance Forum (GSCFF)[1], facilitated by the ICC Banking Commission, set up the ICC Rules Workstream for SCF in 2018. After thorough investigation and careful consideration, the GSCFF has decided to issue this Position Paper on the drafting work of ICC Rules for SCF as a whole. The GSCFF recognizes the market demand for ICC SCF rules. While it considers the conditions for drafting such rules as pre-mature at this stage, the GSCFF will work to promote the progress towards the ICC rulemaking for SCF in the future.

The GSCFF defines SCF in the ***Standard Definitions for Techniques of Supply Chain Finance***[2] as "… the use of financing and risk mitigation practices and techniques to optimize the management of the working capital and liquidity invested in supply chain processes and transactions. SCF is typically applied to open account

1 The Global Supply Chain Finance Forum is a collective group representing a number of industry associations with members around the world, with participating organizations as the ICC Banking Commission, BAFT, the Euro Banking Association (EBA), Factors Chain International (FCI), and the International Trade and Forfaiting Association (ITFA)

2 Drafted by GSCFF in 2016.

trade and is triggered by supply chain events. Visibility of underlying trade flows by the finance provider(s) is a necessary component of such financing arrangements, which can be enabled by a technology platform. SCF is a portfolio of financing and risk mitigation techniques and practices that support the trade and financial flows along end-to-end business supply and distribution chains, domestically as well as internationally. This is emphatically a 'holistic' concept that includes a broad range of established and evolving techniques for the provision of finance and the management of risk."

The importance of SCF as a key growth area in both domestic and cross-border commerce has increased over the past couple of years. Market participants consider it as one of the key mechanisms in helping to bridge the gap in SME financing of trade. The demand for SCF has been driven by multiple factors including economic, regulatory and technology (the impact of these could vary in different countries). In particular the extension of global supply chains and maturing trading relationships have contributed to an increased use of open account settlement methods driven by a demand for alternative risk and liquidity solutions - especially for small and medium-sized enterprises ("SME") with challenging balance sheets when it comes to obtaining other forms of financing. These factors are neatly summarized by a recent WTO paper where it was noted:

"the expansion of global supply chains through the growth of open account trade involving ecosystems of small and medium-sized enterprises (SMEs) embedded in 'made-in-the-world' product assembly processes; a tightening of bank lending since the great financial crisis of 2007-9, particularly for SMEs"[3].

SCF has been widely considered as one of the areas showing significant opportunity

3 Marc Auboin, Harry Smythe and Robert Teh, SUPPLY CHAIN FINANCE AND SMEs: EVIDENCE FROM INTERNATIONAL FACTORING DATA, WTO Working Paper ERSD-2016-04

and greatest potential for growth, and identified as a strategic priority by providers of trade finance solutions. The 2017 ICC Global Trade Finance Survey indicated that almost 30% of respondents identify SCF as the most important area for development and strategic focus in the coming 12 months. This figure increased in the 2018 ICC Global Trade Finance Survey to 38% of respondents identifying SCF as a highly strategic priority expected to drive significant growth, and 43% of respondents (compared with 35% in ICC 2016 Survey) reported that SCF business rose. The 2020 ICC Global Trade Finance Survey revealed further increased figures, with 53% of respondents indicating SCF as an immediate (in the next 12 months) and 33% of respondents as a near-future priority(in the next 1-3 years). Global banks reported an expectation of a significant increase in the usage of SCF over the next five years (one-third expecting over 50% growth).

The 2018 ICC Survey also further highlighted that, among the eight SCF techniques in the ***Standard Definitions for Techniques of Supply Chain Finance***, the four most popular techniques concentrated on payables finance, receivables discounting, factoring and loans or advances against receivables. The share of these four receivables finance techniques accounts for 85% of the eight techniques, with payables finance increasing significantly, ranking with the top share at 28%. Notably, 43% of global survey respondents indicated that payables finance is one of the fastest-growing areas of Trade Finance. The 2020 ICC Survey found out that, receivables discounting (71%) is seen as the most in-demand SCF technique from a client perspective, followed closely by payables finance (54%), loans/ advances against receivables（46%）, and factoring（45%）.

The advantages of SCF propositions are widely acknowledged in helping Buyers and Sellers enhance their efficiency through physical and financial supply chains with alternative risk mitigation techniques in supply chain management and finance schemes. The unique features of SCF propositions, such as payables finance, make SMEs ideal candidates for SCF programs that may help to narrow the global Trade Finance gap, which has been estimated at about USD1.5 trillion for a number of years, by providing access to adequate and affordable levels of trade financing.

Nonetheless, SCF is still in an early development stage, and SCF propositions have evolved differently by region and individual providers. Varying levels of evolution can be observed e.g. in terms of market awareness, product maturity, standardization (pricing, operating models, etc.), and technology.

SCF providers in different locations globally also face diverse regulatory, compliance, capital, tax and accounting requirements and standards. For example, according to the 2018 ICC Survey, 40% of respondents identify Know Your Customer ("KYC") and Know Your Customer's Customer ("KYCC") requirements as persistent challenges in SCF delivery. According to the 2020 ICC Survey, 34% of respondents identified KYC and KYCC as challenges, and 24% of respondents indicated the lack of clarity in accounting and regulatory treatment of SCF solutions as some of the major challenges in SCF delivery.

2. Overview

Inter-governmental organizations and industry associations, including United Nations, the European Commission, ICC, BAFT, FCI, Wolfsberg Group and the GSCFF have developed rules or rule-like documents related to SCF, definitions, guidance papers and reports, which are described in the following.

2.1 SCF techniques related rules

I. ICC rules

The ICC Banking Commission has successfully set up universally adopted rules for traditional trade finance products such as Letters of Credit (UCP), Standby Letter of Credit (ISP98), Demand Guarantees (URDG) and Documentary Collections (URC)... Additionally, ICC has issued new electronic rules (eRules) to advance the digitalisation of letters of credit and collections, namely eUCP Version 2.0 and eURC Version 1.0[4]. With the development of SCF, the ICC has also focused on SCF in rulemaking decisions in recent years as follows:

a. URF

ICC ***Uniform Rules for Forfaiting*** (URF)[5], in force since 2013. Forfaiting is one of the eight SCF techniques outlined in the SCF Definitions issued in 2016.

b. URBPO

In 2013, ICC developed the ***Uniform Rules for Bank Payment Obligations*** (URBPO)[6] deploying the technology platform (the Trade Services Utility) hosted by SWIFT limited solely to interbank interactions. With the increasing development of SCF, the URBPO is a set of rules that respond to market demands for new solutions to deal with the growing use of open account in trade and the increasing move to digitalize processes.

c. URDTT (work-in-progress)

Due to being limited solely to bank-to-bank interactions, being limited to a single technology platform and restricted to engaging with at most four parties, the URBPO in its existing format is not considered suitable to accommodate emerging technologies.

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4 https://iccwbo.org/media-wall/news-speeches/icc-banking-commission-releases-new-erules-use-electronic-documents/

5 https://iccwbo.org/media-wall/news-speeches/icc-rules-on-forfaiting-now-in-effect/

6 https://iccwbo.org/media-wall/news-speeches/icc-releases-guidelines-for-creation-of-bpo-customer-agreements/

On December 5, 2018, the ICC Banking Commission Executive Committee approved a proposal to draft a new set of rules under the working title “Uniform Rules for Digital Trade”, with the aim of developing a high-level framework outlining obligations, rules and standards for the digitalisation of Trade Finance. Pursuant to feedback from the ICC National Committees, the title of the Rules was changed to “Uniform Rules for Digital Trade Transactions (URDTT)”.

The objective[7] is to codify those events in a commercial transaction that support the roles and obligations of the participants in digital trade transaction independent of the underlying technology supporting the transaction.

II. Convention on International Factoring by UNIDROIT

In 1988, the International Institute for the Unification of Private Law (UNIDROIT) drafted and promulgated the ***Convention on International Factoring***, which took effect on May 1st, 1995. The Convention addresses elementary aspects of factoring.

III. Factoring Model Law by UNIDROIT (work-in-progress)

In May 2019, the UNIDROIT Governing Council approved the project of developing a Model Law on Factoring for the UNIDROIT 2020-2022 Triennial Work Programme proposed by the World Bank Group (WBG) in December 2018.

WBG made such suggestion for three main reasons:

(i) To facilitate the use of factoring as an important form of financing increasing access to credit;

(ii) To address the constraints in access to credit as a limit on economic growth,

[7] ICC’s email notice on Jan. 30, 2019: ICC Banking Commission Working Group on Digitalisation in Trade Finance: Uniform Rules for Digital Trade

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particularly in developing countries and emerging markets; and

(iii) To address the gap that currently exists in international standards regarding factoring. The proposal noted that existing instruments largely focus on international or cross-border transactions and do not provide sufficient guidance to States to develop functional domestic factoring frameworks.

The Model Law will be a standalone instrument for adoption by any State looking to reform their domestic law to facilitate factoring, with a proposed focus on developing States and emerging markets that want to reform their existing domestic factoring laws but are not yet in a position to undertake a full reform of their secured transactions law.

The Factoring Model Law Working Group has started the discussion of issues that they may wish to consider in preparing the Model Law since July 2020.

IV. United Nations Convention on the Assignment of Receivables in International Trade by UNCITRAL

To make financing of international trade easier and more accessible, the ***United Nations Commission on International Trade Law*** (UNCITRAL) published the United Nations Convention on the Assignment of Receivables in International Trade in 2001, a Legislative Guide on Secured Transactions in 2007, and a Guide on the Implementation of a Security Rights Registry in 2013. These laws have set up regulations on issues such as the forms, legal effects related to receivables assignment.

V. General Rules for International Factoring (GRIF) by FCI

As the largest factoring business industry association[8], Factors Chain International (FCI) released the Code of International Factoring (initially entitled the 'Shield Agreement') among its members in 1969 regulating the operations of international factoring. Following numerous revisions, the rule was renamed as ***General Rules for International Factoring*** (GRIF) in 2002 and specifically addresses the operations of two-factor international factoring among FCI members.

FCI created the Rules of Arbitration in 1976, as all disputes between members are required to be resolved via arbitration.

The Rules of FCIreverse and Rules for Islamic Factoring were published by FCI in recent years.

VI. Model Factoring Law by IFG

International Factoring Group (IFG), a global trade association based in Belgium, created the Model Factoring Law on factoring in 2014. FCI refrained from further developing the IFG Factoring Model Law, inherited by merger in 2016. Instead, FCI supported an initiative supported by the World Bank for the creation of a new global model law on factoring by the UNIDROIT, which is expected to come into effect in 2022.

2.2 SCF techniques definitions, guidance or reports

2.2.1 Standard Definitions for Techniques of Supply Chain Finance by GSCFF

To establish a common global understanding and work towards the international

[8] Annual Review 2019, Factors Chain International (FCI): Over the past 20 years, factoring has grown on a CAGR basis of nearly 10% p.a. By the end of 2018, world factoring volume is over EUR 2.76 trillion, while Factors Chain International (FCI) members accounted for nearly 60% of global factoring volume, and nearly 90% in international cross border volume.

standardization of Supply Chain Finance (SCF) techniques, Global Supply Chain Finance Forum (GSCFF) published ***Standard Definitions for Techniques of Supply Chain Finance*** in 2016 as the first step.

The Standard Definitions for Supply Chain Finance Techniques have been shared among the members of each of the contributing organizations representing more than 1,000 leading banks, factoring and forfaiting companies, technology and services providers. Further relevant institutions like banking associations, media, the educational sector, regulatory and government agencies, law firms, accounting firms and further important stakeholders were made aware of the standard definitions.

2.2.2 SCF techniques guidance papers by GSCFF

To drive further clarity and awareness on SCF terms and techniques and win uniform adoption of the generally accepted SCF practices on an industry-wide basis, the GSCFF had started drafting a series of guidance documents on major SCF techniques based on its 2016 ***Standard Definitions for Techniques of Supply Chain Finance.*** On 19 June 2019, the GSCFF released its first guidance document, ***Market Practices in Supply Chain Finance: Receivables Discounting Technique***.

To address the concerns raised from 2019 onwards on Payables Finance, particularly following the collapse of certain companies and the alleged role of Payables Finance, the GSCFF released its factsheet paper ***Payables finance – how it helps global supply chains*** in March 2020. The paper provides clear information on the product, clarifies the definition of Payables Finance and addresses the concerns that were raised by rating agencies and accounting firms.

In response to the increased criticism on Payables Finance, the GSCFF issued a further Q&A document in August 2020. The report, ***Ensuring payables finance remains a force for good***, aims to address criticisms across three key areas: the potential adverse impact on suppliers, issues relating to financial reporting and transparency, and overall programme risk.

2.2.3 BAFT / GTIC Principles Paper on Payables Finance

To drive further clarity and awareness around Payables Finance, the BAFT / GTIC issued a Principles Paper in September 2020. This paper outlines acceptable practices that qualify a product as 'Payables Finance' as described in the Standard Definitions for Techniques of Supply Chain Finance.

2.2.4 The Wolfsberg Group, ICC and BAFT Trade Finance Principles 2019 amendment

In 2017, the ***Wolfsberg Group, ICC and BAFT Trade Finance Principles***[9] were published, covering Trade Finance products like Documentary Credits, Documentary Collections, Demand Guarantees and Standby Letters of Credit. The document specifically relates to trade based money laundering guidelines.

With the increasing focus on SCF, the trade finance industry called for additional guidance on SCF techniques, which the 2017 version document did not cover. As a result, the ***Trade Finance Principles 2019 Amendment*** was enhanced with a section on open account trade (defined for Payables Finance and Receivables Discounting in the ICC Standard Definitions of Supply Chain Finance).

[9] A joint ICC-Wolfsberg Group Trade Finance Principles Drafting Group9 was set up in April 2014 to redraft and update the Wolfsberg Trade Finance Principles paper in the style of ICC guidance, with a view to raising and standardizing the practice level of Financial Crime Compliance (FCC) within the Trade Finance industry. Drafting group includes members from Wolfsberg Group banks, ICC members globally and BAFT.

2.2.5 ICC Trade Register Report

To reflect the shift in trade financing from documentary trade finance towards open account term and to provide banks, investors and regulators visibility on the credit risks in SCF, the ***2018 ICC Trade Register Report*** expanded its scope to include supply chain finance techniques. The ICC Trade Register provides loss given default (“LGD”） estimates based on the data provided by participating banks, and Payables Finance was selected as a pilot.

The SCF data set in the Trade Register for the first two years is relatively small, but it evidences that the probability of default for SCF is comparable to other short-term trade finance products.[10]

ICC will further expand the scope of the ICC Trade Register to include operational and fraud risks, and collect data to substantiate and disaggregate these results so that they can be used to satisfy the requirements set out by regulatory, capital or accounting policies.

3. Premature conditions for drafting ICC SCF Rules

It is agreed that greater standardization, transaction rules, legal and regulatory frameworks in the area of SCF are required, as they will help to promote sound SCF practices, produce better data quality, bring transparency to SCF providers, regulators,

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[10] 2018 ICC Trade Register Report : Exposure-weighted default rates for SCF in 2017 were 0.11%, comparable to the long-term average for trade finance products of 0.15%, and the obligor-weighted default rate is also 0.11% – below all trade finance products except for export L/Cs.

2019 ICC Trade Register Report:: Exposure-weighted default rates for SCF in 2018 were 0.13%, a slight increase from 0.11% in the previous year, and comparable to other trade finance products .The obligor-weighted default rate increased from 0.11% to 0.23%(below all documentary trade finance products) in 2019 Report (except for export L/Cs). Defaults weighted by transactions rose to 0.01% in 2018 from <0.01% in the previous year.

legal bodies, accounting firms, investors and other SCF stakeholders.

To achieve standardization, increase awareness and utilization of the SCF techniques, active advocacy of the ***Standard Definitions for Techniques of Supply Chain Finance*** and SCF techniques practice guidance papers is required to achieve a wider global adoption of the practice and consensus over SCF techniques in the market.

3.1 ICC's rule making general preconditions

As a rulemaking body for global commerce, ICC monitors the global market development and drafts new rules, or revises existing rules, in order to accommodate market demands and the needs arising from the development of global trade in all its aspects. This includes, for example, transportation, insurance, technology, accepted practices, new practices, or responses to serious problems that have arisen due to the lack of rules or ambiguous interpretation of rules.

It is paramount that, in order to initiate a new rules-drafting process, a sufficient business plan must be in place. The need for a strong business case is essential in order to justify a rules-drafting process. Only once the ICC Banking Commission Executive Committee has approved the business case, a rule-drafting process can commence.

3.2 Targets and benefits for future ICC SCF Rules

ICC rules for SCF should aim at delivering globally accepted rules similar to other ICC publications, which will benefit all parties involved in SCF activities, and promote developments in risk assessment, the legal and regulatory framework.

ICC rules for SCF should focus on various issues related to supply chain finance techniques not covered by local laws or regulations, reflect and promote generally accepted sound and standard industrial practice, remove confusions and uncertainties, and act as references for all parties concerned.

Any proposed ICC rules for SCF must also be in alignment with the format and structure of other ICC rules whilst stringently complying with ICC rulemaking procedures.

3.3 Preconditions for ICC SCF Rules

To make any proposed ICC rules for SCF as successful as existing ICC rules (for example UCP 600 for Documentary Credits, URDG 758 for Demand Guarantees and other ICC rules), the drafting of ICC rules for SCF will first need to, at the least, take into consideration the following preconditions:

a. The need for uniform industry-wide adoption of the standard definitions of SCF techniques and common practice;
b. Collection of sufficient market feedback which may provide substance to the potential ICC rules for SCF;
c. Acceptance by market participants (i.e. ICC NC's);
d. Liability of acting parties if rules are applied;
e. Feasibility of the rules being applied in both domestic and/or cross-border practice;
f. Rulemaking approaches as to include general SCF techniques or specific SCF techniques and the structures of the rules;
g. Dialogue and engagement with regulators;
h. Sufficient market demand.

While there is clearly a market demand for rules, market participants still have different interpretations – in spite of the standard terminology the GSCFF has published. A relevant aspect in that context is the large grey area between 'classic' Payables Finance as the GSCFF promotes it and various shades of payment undertakings, where a receivable may be purchased or not. Different interpretations may be historically grown or technically driven, or simply be maintained for competitive reasons.

Under the current market conditions, it seems unlikely that all above preconditions for rules can be fulfilled. There are however, indications towards a further standardization, which may ultimately also make ICC Rules for selected SCF techniques more realistic in the future.

4. Conclusion

Without doubt, market demand for ICC SCF rules exists, with an expectation that SCF rules would be similarly successful as the existing ICC rules guiding other Trade Finance products. The industry-wide adoption of the standard definitions of SCF techniques and common practice has made considerable progress through advocacy efforts; however, wider adoption of such definitions and common practice must be evidenced before meeting the requirements of rulemaking. Generally, an industry consensus on the basics of rulemaking must be achieved to ensure the rules satisfy an actual market demand that would be widely applied and eventually adopted by the international trade finance community. More market research may be required to better understand the exact market demand in that respect.

After careful study, the GSCFF workstream on ICC Rules focused on reviewing and considering the development of ICC Rules for SCF, as analyzed above, recommends that the landscape for developing SCF rules is still premature at this stage.

In the meantime, the ICC will drive the subject forward, and continue to work together with GSCFF and other industry organizations on advocacy and promotion, so as to drive globally broad adoption of standard definitions of SCF techniques and practice, whilst collecting market feedback on the customs and practices to be included in any future ICC rules for SCF.

To further establish the definitions published by the GSCFF, market participants are asked to incorporate the standard definitions into their daily operations and align their products and services accordingly, while retaining their freedom in differentiated products and services in the market.

Once the GSCFF together with its sponsoring organizations consider the preconditions for drafting ICC rules for SCF as fulfilled, the formal drafting work will be initiated in accordance with ICC's rulemaking procedures.

The GSCFF workstream on ICC Rules for SCF therefore to suggests revisiting the matter in more detail at the Spring Meeting of ICC Banking Commission in 2022.