Digital Negotiable Instruments and Supply Chain Finance (SCF)

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1. Introduction and Executive Summary

Supportive legal reform, continued advancements in technological capability and a stubbornly persistent global trade finance gap provide a unique opportunity for the industry to pivot towards a truly scalable model to ensure funding reaches SMEs through to large corporates.

As well as benefits for business, embracing the potential of digital negotiable instruments ("DNIs") within established financing techniques such as SCF, offers transformative benefits for lenders, technology providers, insurers, and investors.

This paper considers the potential opportunity to capitalise on the above dynamics, whilst focusing on differences between paper form and electronic form documents.

The conclusion of this paper, following engagement with industry professionals with relevant specialisms, is that the market should feel confident and assured in embarking on the journey to using digital trade instruments within SCF. Definitions of SCF techniques reflecting current market practice can be found at the GSCFF website here.

2. Context

Whilst SCF has delivered undeniable benefits to the global economy, it could be argued it continues to fall short in the context of liquidity reaching deep enough into supply chains, meaning smaller (often SME) suppliers are unable to access the benefits a SCF programme offers. Similarly, those SME suppliers face a high cost of borrowing or even an inability to access working capital required to grow their business.

The position has undeniably improved with new, technology-driven providers coming to market with an ability to reach deeper into supply chains. That said, we continue to see a stubborn (and growing) trade finance gap, which suggests more can be done.

An increased use of DNIs across multiple SCF techniques provides an opportunity to address these stubborn challenges and move to an environment of more effective access to credit for businesses of all sizes.

3. Legal Reform

The passing into English law of the Electronic Trade Documents Act 2023 ("ETDA"), heralds a new dawn for international trade by simplifying global trade finance processes and making working capital finance more accessible to a wider range of buyers and suppliers. The legal recognition of an electronic trade record has laid the foundation to think and act differently to make trade cheaper, safer, and more efficient with electronic equivalents of paper trade documents enjoying the "same legal treatment, effects and functionality" as their paper equivalents.

The ETDA is a helpfully short and concise Act which reflects the essence of the 2017 UNCITRAL Model Law on Electronic Transferable Records (MLETR), taking into account particular features of English law. A handful of other countries have already enacted similar legislation and there are a growing number who have indicated they will embark on a similar path. In the meantime, greater consistency of legal standards across nations will support digital trade adoption.

A critical aspect introduced by ETDA is that of a "reliable system" as set out in Section 2 of the Act. ITFA has published an addendum to its DNI Handbook dealing with some of the practical aspects of managing "reliability" which can be found here.

4. Digital Negotiable Instruments (DNIs) and Supply Chain Finance (SCF)

Negotiable Instruments in paper form (Bills of Exchange, Promissory Notes) have historically been used more widely in documentary and structured trade as opposed to SCF. Similarly, invoices (which are inherently non-negotiable) have almost exclusively been used in SCF. Negotiable Instruments are more robust, are unconditional and independent, i.e. free from performance risk but, until recent legislative change, suffered from needing to be in cumbersome paper form.

With the passing of the ETDA, an opportunity exists to use DNIs more widely as a means to improve working capital and earnings by delivering financing flexibility to existing frameworks (including the option of post maturity finance), better access to liquidity for SMEs, enhanced data security, as well as attracting additional liquidity from non-traditional sources by accessing a broader range of financing partners.

DNI based financing solutions also offer independence from restrictive, non-fungible legal frameworks by using standardised payment and financing instruments. They also enable payment terms to be extended without the need to change or renegotiate underlying supply contracts. Excitingly, a number of ITFA members are looking at the possibility of using digital tools and platforms to switch seamlessly from one kind of electronic trade document to another across the same supply chain. For example, an electronic bill of lading can be exchanged for an electronic bill of exchange or promissory note once goods have arrived and trigger a payment or financing from a bank.

The potential opportunity of using DNIs in SCF is significant, but we are still at a nascent stage. As we have shown above, we believe that this change can scale rapidly, especially considering new additional functionalities that come along with the use of modern data encryption and digital ledger technologie**s.**

5. SCF Accounting Treatment and Rating Agency View

New SCF disclosure requirements introduced by FASB and IFRS, have again brought into focus the vexed question of whether SCF should be accounted for as debt or trade payables.

There has been a consistent position taken on this point by the audit community, which focuses on the substance of the underlying commercial contract rather than the method of settlement used. This means that use of a trade instrument such as a DNI or e-Letter of Credit will not, in principle, change the analysis but may still offer some benefits where terms are not in excess of industry norms and there are no other "red flags" – see the ITFA guidance paper here.

As a result, for the same underlying commercial contract, there is no change to disclosure requirements whether a paper or digital negotiable instrument is used.

Buyers who use SCF need to continue to make an honest assessment on whether SCF is being used to extend terms beyond the empirical industry norm or is truly building resilience within their supplier base.

Rating agencies follow the same approach with analysis of the underlying commercial contract being the primary reference point on reclassification.

As the accounting changes are about disclosure, SCF users need to produce accurate data. ERP systems are well placed as the single source of truth when compiling accounting disclosures and certain technology providers already offer a service of managing SCF and other financing programmes.

The point remains that a DNI can replace a paper negotiable instrument and, all other things being equal, will allow a greater chance of consistent treatment from auditors and rating agencies.

Furthermore, in view of discussions around the planned EU Late Payment Regulation (LPR), negotiable instruments, being trade-related payment instruments, may offer a way to ease any limitation in payment tenors that is bought about by the LPR by paying with a bill of exchange/ promissory note and obtaining an additional deferred payment period.

Conclusion

The digitalisation of trade offers significant potential benefits to the global economy and can make trade faster, cheaper, safer and more sustainable.

Practitioners should feel confident when choosing to grow the use of DNIs in a SCF context, that there is no difference between current practices of using paper documents.

Greater collaboration and understanding between market participants will drive standardisation, better understanding, and confidence to adopt DNIs in SCF which will lead to market growth and benefits for all.