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The revolutionary development that's turning supply chain finance on its head

Dominic Broom, SVP Working Capital Technology, Arqit, and Markus Wohlgeschaffen, Managing Director, Traxpay, explain why the UK's new Electronic Trade Documents Act marks an inflection point for global trade, allowing funding to be based on a supply chain's strongest link, and driving opportunities for businesses across the supply chain.

Digitalisation is well-documented as a goal of the global trade industry. Considerable efforts are underway to enable the transition from manual processes centred on paper documents, to efficient, highly secure digital solutions that leverage electronic documentation and automation.

Trade is an enduring, age-old industry built upon established rules and practices that are key to supporting safe, effective global transactions. These rules were designed to facilitate trade in a paper-based world – to the degree that using physical trade documents is in fact a legal requirement in many jurisdictions – at least for key documentation.

This is about to change. The passing of the Electronic Trade Documents Act (ETDA) by the UK Parliament in July is likely to have gone unnoticed by many businesses. But this legal development represents a landmark for trade.

Historically, the exchange of negotiable trade documents such as promissory notes or bills of exchange was governed by principles such as "possession" and "delivery", presupposing a tangible medium. The ETDA, which came into effect on September 20th, now allows for digital documents to also serve this function, making electronic negotiable documents legally recognised in the same way as their paper-based equivalents. Similar legislation has already been adopted in Singapore and G20 nations have committed to enacting legislation based on the Model Law for Electronic Transferrable Records in the near future.

This seemingly small amendment to the law translates to big benefits for businesses – opening the door to a new digital age for trade finance and, in turn, creating opportunities to optimise working capital solutions for the end-to-end supply chain.

Supply chain finance today

The changes being implemented through ETDA are hugely significant given the number of trade contracts written globally under English law. But the real significance is its transformative

impact on supply chain finance (SCF), which has been hampered from its inception by the inefficiencies of the paper trail.

Within a supply chain, the business that most urgently needs access to cash is usually the smallest entity at the end. And yet, the structuring of today's SCF solutions means they are often those to whom SCF is least available, because as the “weakest link” – i.e. the smallest business with the tightest balance sheet – in a supply chain, banks are often unable or unwilling to take on the perceived risks, or the KYC costs, of many SMEs.

Lengthy supply chain cycles – which involve specific negotiated payment terms, including deferred payments, between individual buyers and suppliers at each stage of the chain – mean that smaller suppliers’ working capital frequently comes under significant strain. None more so than that of the very end supplier, who often needs to resort to expensive factoring solutions as the only available option to plug the payment gap or, potentially, be dissuaded from exporting altogether.

Certainly, this “bottom up” approach to financing supply chains results in inefficiencies for corporates looking to secure their supply chains and decrease costs. It is empirically proven that the revenues of all participating stakeholders increases when supply chains are robust and interruptions avoided. Being able to inject liquidity to safeguard supply chains is therefore of utmost importance to every party involved.

ETDA: basing finance on a supply chain’s strongest link

This is where digital negotiable instruments (DNIs) come in. Taking the form of digital promissory notes (DPNs) and digital bills of exchange, they are flexible and scalable, and effectively act as a binding promise by a corporate to pay on a specific date. By integrating these tools into supplier finance arrangements, banks can dispense with separate assignment agreements and irrevocable payment undertakings (IPUs), which are necessary for the transfer of non-negotiable instruments such as account receivables/invoices.

DNIs thus function as a standardised risk transfer mechanism, enabling corporates to invert the “bottom up” working capital lending dilemma, as the funding is tied to their own, far stronger, creditworthiness, rather than that of the smallest supplier. This enables a far more effective lending structure, with borrowing based on the corporate’s superior credit profile and financing then cascading down to suppliers, and the reach of the SCF programme being able to extend to the “long tail”, smaller businesses. This way, corporates can inject and safeguard liquidity throughout the chain, with everybody benefitting from their financial clout. In addition, the use of bills of exchange act-based negotiable financing instruments ensures fungibility for an expanded investor base.

As such, the scalability of deep-tier SCF (DTSCF) is being transformed. Indeed, smaller links in the chain, rather than accepting expensive factoring deals, therefore have far quicker and more reliable access to working capital, plus lower funding costs. Corporates able to offer this can also better negotiate benefits: e.g. discounts with those suppliers. They can also expand by creating new connections to new partners and create resiliency in their supply chain. The result is the democratisation of SCF.

In with the new: benefits for all

And with DNIs adopted, the benefits multiply. One is that, unlike current SCF solutions, smaller corporates that do not use enterprise resource planning (ERP) software can upload and submit invoice data using CSV files. DNIs are also flexible. Their application does away with the rigidities of existing SCF solutions, such as invoice finance, returning control of supply chain processes back to buyers and suppliers and all this fully automated without having to change existing processes. For example, corporate treasuries, working in tandem with procurement departments, can choose between self and third-party funding as liquidity needs fluctuate with the business cycle. In most cases the external finance will be treated as supplier finance as opposed to bank debt. Finally, the use of promissory notes provides an opportunity for buyers to extend payment terms without having to modify existing supply contracts.

Perhaps one of the greatest benefits is that DNIs are generated from the “source of truth”, the ERP system of corporate clients and eminently traceable. Compared to paper-based instruments, DNIs are almost impossible to duplicate or tamper with because proof of their existence and ownership is quickly verifiable on a distributed ledger, thereby making SCF processes less vulnerable to financial crime. DNIs and all related information such as for example invoice data, are digitally sealed and only exchangeable using highly secure digital keys, ensuring undisputable transfer from one holder to another. This end-to-end digital process also enhances the transactional audit process. In so doing, the risk transformation and liquidity provision also provide opportunities for automation. As it stands, Arqit’s TradeSecure™ is the only DNI service that is able to generate instruments that are secured against all known forms of computing attack.

Leveraging DNIs in trade finance will be a far simpler process now that the ETDA is in force. This UK development also helps to encourage global adoption, which is being progressed at the UN level in the Model Law on Electronic Transferrable Records (MLETR). The MLETR is being considered (at various stages) in all the G7 economies, although the UK is the first to adopt it into law via ETDA.

A timely solution to a spiralling scourge on global trade

The ETDA could not come at a more important time. The new legal recognition of digital documents and its enablement of more effective SFC coincides with the release of new figures from the Asian Development Bank (ADB) on the global trade finance gap. The gap, which represents the shortfall between the requests made for funding to support imports and exports, and the funding that is approved, now stands at US$2.5trillion. This figure not only underscores a mammoth shortfall in funding support, but the US$8billion growth over the past two years reveals a rapidly escalating situation. Between 2018 and 2020, there was an increase of US$2billion. This means the growth of the gap is up 400% on the previous period, with the overall gap widening by US$1trillion in the last four years alone.

This growth has been driven by the extreme headwinds that are affecting global trade. Still finding their feet following the impacts of the pandemic, many companies were propelled into further uncertainty by Russia's invasion of Ukraine, which has caused supply chain and trade route disruption. Moreover, at a time when stability and access to working capital are essential, businesses are facing high levels of inflation in addition to the challenging trade finance landscape.

These latest figures starkly emphasise the need and the urgency for more effective supply chain solutions – and reinforce the value that ETDA, and the DNIs it supports, can bring to the businesses involved in international trade, and to the health of global trade as a whole.

The move towards digitisation through DNIs anchors supply chains to corporates, leveraging their strength to create opportunities for scaling. Their widespread adoption will result in new finance becoming available to a wider range of businesses – thereby acting as a valuable, viable solution to the trade finance gap – as well as the adoption of new financing tools by banks for corporate clients. Ultimately, it will modernise a core component of global trade – and set in motion optimised working capital finance for all.