

Using trace:original Digital Original Documents to Support UK Foreign Trade

USE CASES AND BENEFITS

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enigio



TRADE
ADVISORY
NETWORK



Context

There are many situations where an original document is required to evidence the legal enforceability of a party's rights or obligations. Original documents are used extensively in trade finance and forfaiting. In many cases, these documents confer certain rights upon the holder of the original and provide for such rights to be transferred by the holder to another party by endorsement and delivery of the original document. The most common transferrable documents used in trade finance and forfaiting are negotiable payment instruments and documents of title.

In order to maintain its legal enforceability, a digital document must replicate the properties of the paper equivalent with regard to:

- its nature as an original;
- its function relative to a holder (i.e. the party that has 'possession' of the original document); and,
- its transferability.

Replicating these properties in a digital document has not been possible until now.

Enigio has solved this problem with a patented solution, 'trace:original', that safely creates and manages a digital document that preserves the three essential properties identified above:

- The document is unequivocally an original (i.e. there can only ever be a single holder that can

have 'possession' of the original and it can only be controlled by this single holder at any point in time)

- The rights of a holder are embodied in the digital original document
- The ability of a holder to transfer rights by endorsement and delivery to another party is maintained

All of this is achieved using trace:original and, unlike some of the trade and supply chain related consortia, there is no requirement to extract business content into a blockchain and nor is there a need to operate within a closed ecosystem and associated rule book.

In this paper we discuss the problems with paper documents and examine three specific use cases where the use of trace:original for creating digital original documents is very easy and delivers significant benefits to all parties involved:

- UK SME/Mid Cap Exporter
- Multinational Corporate (MNC) Payables Finance
- MNC Receivable Finance

Before reviewing the advantages of digital documents relative to paper documents, we also consider the legal obstacle, under English Law, which is delaying the adoption of digital negotiable instruments.

Legal Challenge

Under English Law, negotiable payment instruments are governed by the Bills of Exchange Act (1882). Though the concept of digital documents clearly did not exist when this was written, our legal advice suggests that there is nothing in the act itself that would prevent the use of digital bills of exchange, provided all of the properties of paper, as set out elsewhere in this paper, are replicated. As noted, the technology now exists to comply with this requirement.

The legal challenge relates to the concept of 'possession', which is essential to the negotiability of a bill of exchange or promissory note. The right to get paid is transferred by endorsement and delivery to the new holder, who now has 'possession' of the instrument.

Under the current interpretation as provided for in the 2007 House of Lords case of *OBG v Allan* and in 2014 case of *Your Response v Datateam Business Media*, it is not possible to have 'possession' of an intangible. A digital document is deemed to be intangible.

We understand that discussion is at an advanced stage with the Law Commission and the Ministry of Justice regarding the need to address this legal anomaly which will allow the widespread use of digital negotiable instruments as an enabler for growth in trade, particularly during the recovery from the economic downturn caused by Covid-19.



Generic issues with paper

Problems

- Volume:
 - 4 billion paper documents circulating associated with trade.
- Cost:
 - Printing, indexing, secure storage, retrieval, scanning and delivery all add cost to the operating model.
 - Version control is difficult to police and adds cost.
 - Authentication and provenance are difficult to prove and add cost.
 - Missing documents and delayed delivery of documents cause increased consequential costs (e.g. demurrage).
- Operational efficiency and risk:
 - OCR technology is limited and Straight Through Processing is therefore not possible.
 - Data in paper documents cannot be accessed digitally, making it impossible to perform automated checks and reconciliation.
 - Often paper documents are scanned or copied creating multiple versions of the data, compounding the problem and adding additional cost to the processes.
 - Delays in processing of payments or provision of finance whilst documents are in transit.
 - The same data contained in documents is checked and re-checked at multiple points.
 - The same data is re-keyed into different documents, leading to delays and errors.
 - Misplacement or loss of critical documents creates cost and triggers long and cumbersome internal and external compliance processes.
- Fraud:
 - It is easy to produce fake documents.
 - It is difficult to authenticate or validate paper documents or prove ownership of originals.
- Working capital impact:
 - All of the above can cause delayed payments, delayed access to finance and restricted access to finance.
- Business continuity:
 - As we have seen during the current COVID-19 pandemic, if the paper cannot be delivered, the financial processes which depend on paper cannot be executed.
- Environmental impact:
 - Paper production is environmentally unfriendly and moving paper around the globe creates a massive carbon footprint

Positive attributes

- Portable:
 - Paper documents can be moved between places and delivered from one party to another in a variety of ways (e.g. post, courier etc.)
- Paper documents are accessible to all:
 - Access is without restriction or the need for any specific technologies.
 - Foreign languages documents may be read by anyone able to speak the language and may be translated for the benefit of those that don't.
- Paper documents can be read by humans
- Paper documents can be signed without the need for technology (i.e. a 'wet-ink signature') and the obligations of the signatory are recognised in law.
- Paper documents include negotiable payment instruments, documents of title and other official documents where possession of the original is fundamental to their function (facilitating the provision of finance or the release of payments).

Use Cases

UK SME/MidCap Exporter

Problems

- Limited access to finance:
 - Up to 90% of exports are on open account terms, so traditional LC finance is not available.
 - Export factoring/invoice discounting solutions are not fully effective:
 - Impacted by banks' restrictions on overseas receivables relative to domestic receivables.
 - Strong preference for 'whole turnover' approach reinforced by an 'all asset debenture'.
 - Banks need to undertake due diligence in importing country to verify enforceability of debt and will, as a consequence, usually need to work with a local correspondent using the 'two-factor' model.
 - Bank's title rights to the receivable are subject to compliance by their client with contract terms (a.k.a. dilution risk).
 - Combination of dilution risk, stringent invoice eligibility criteria and advance rate result in availability typically being restricted to 50-60% of aggregate value of invoices.
 - Excessive reliance on overdraft as a source of finance.
 - Being an unstructured finance solution, with no visibility or control of use of funds or source of repayment, limits are constrained by tangible security valuations.
 - Overseas receivables typically attract a very low weight for security valuation purposes.
 - Overdraft limits cannot typically accommodate growth or longer transit or credit periods associated with exporting.

- Inefficiency of traditional (paper-based) trade finance solutions:
 - Resistance to issuing LCs by overseas buyers due to cost, complexity and impact on credit facilities.
 - Reluctance to using Collections due to inefficiency of paper-based process.
- Inadequate risk mitigation:
 - Credit insurance covers debtor insolvency but benefits undermined in case of alleged contractual dispute.
 - So called 'non-recourse' advances are subject to contractual fulfilment by the client.

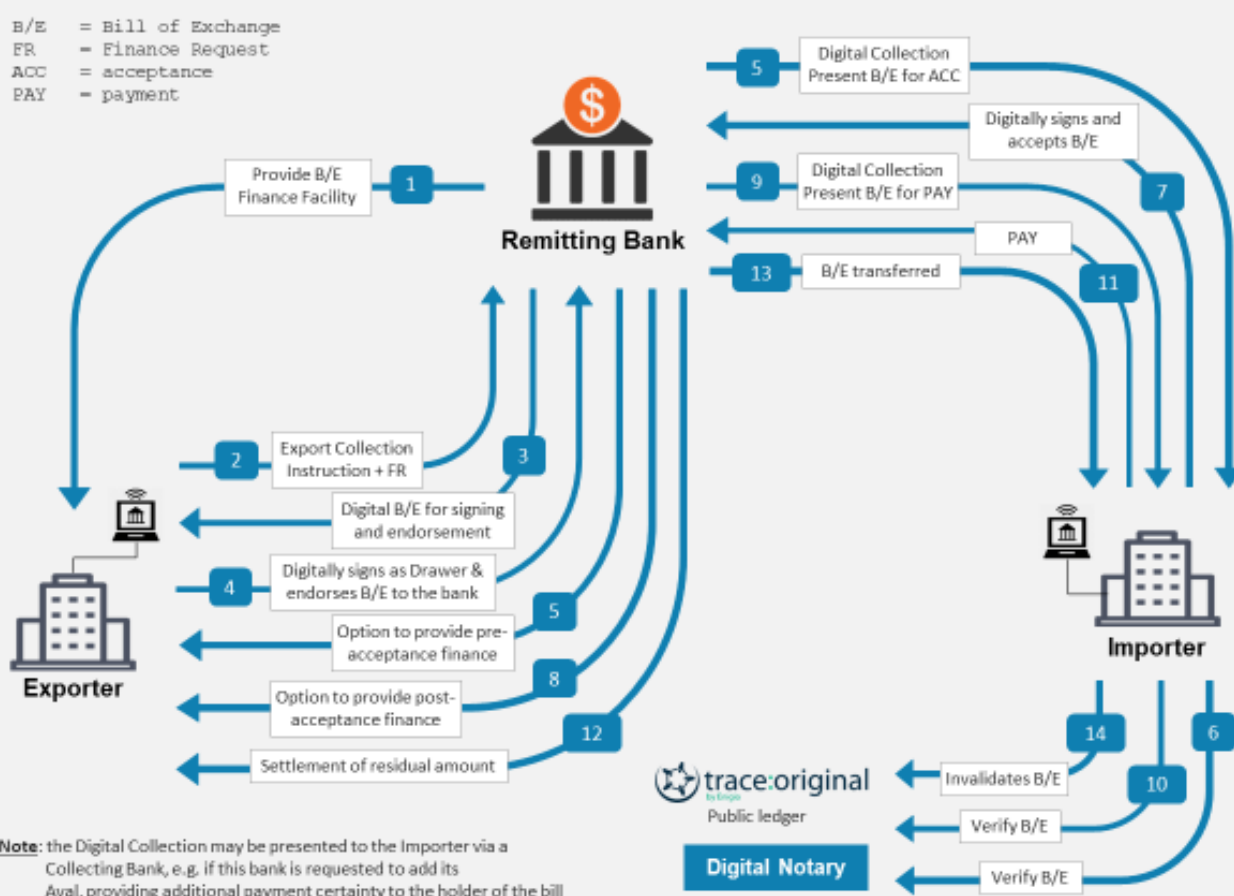
trace:original solution

- Increased access to finance:
 - Using digital bills of exchange, the benefits of the traditional Collection can be realised, including:
 - Acceptance of the bill by the buyer signifying approval of the invoice.
 - The accepted bill is an unconditional, irrevocable, stand-alone payment undertaking which is separate from, and independent of the underlying contract to which it relates. Once a bill is accepted, the buyer cannot avoid liability to make payment by alleging contractual dispute.
 - The collection process gives the bank visibility and control of the source of repayment and early warning of a potential default.
 - Banks can avoid having to undertake due diligence on enforceability of receivable by relying on the accepted bill.
 - Finance of accepted bill, underpinned by credit insurance, can be 'non-recourse', freeing up the client's credit facilities to be used to finance additional business.

- Operational efficiency:
 - The processing of the Collection can be digital, seamlessly integrating into an efficient workflow.
 - No need to transport paper documents from client to remitting bank, from remitting bank to collecting bank or from collecting bank to buyer. The bill of exchange is created digitally and is transferred from party to party digitally.
- Enhanced risk mitigation:
 - Once bill of exchange is accepted, the buyer cannot avoid liability for payment by alleging
- If the accepted bill of exchange is then dishonoured for payment, it can be 'noted and protested' locally and used as prima facie evidence of the unpaid debt in a claim under the credit insurance policy.
- Finance of the accepted bill, underpinned by credit insurance, can be 'non-recourse', eliminating credit risk on the buyer.

Fig. 1 | trace:original, completely digital e2e process

SCENARIO 1 - UK SME/MidCap Exporter (Finance under Export Collection)



MNC Payables Finance

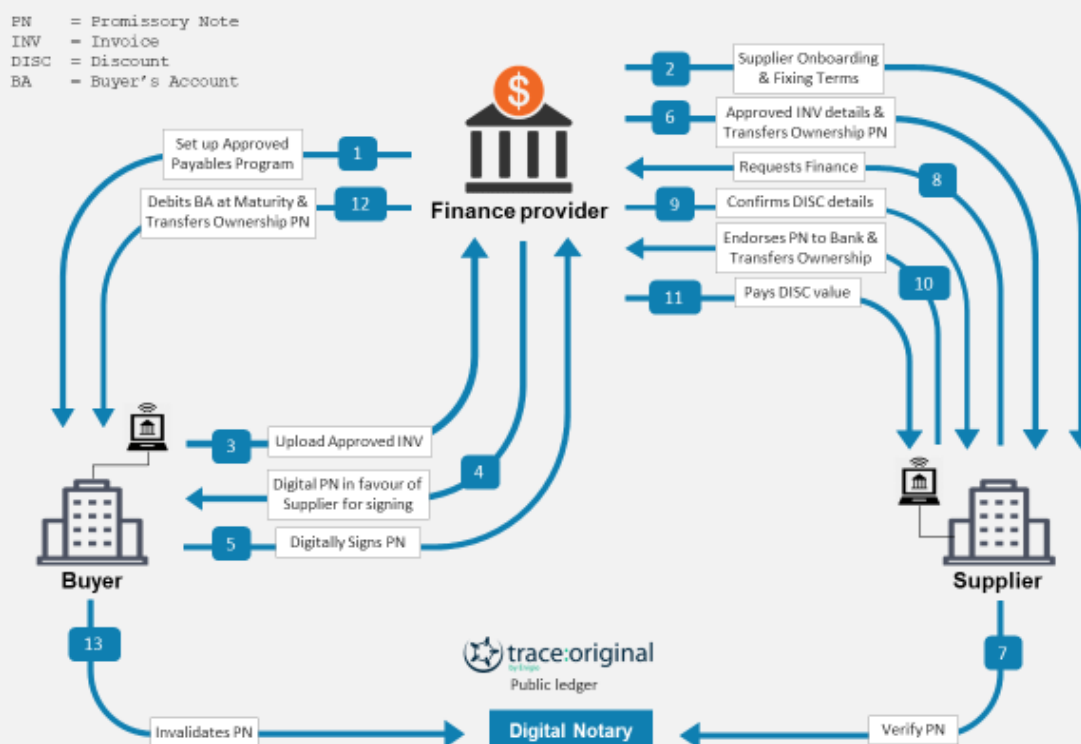
Problems

- Supplier onboarding:
 - In order to maintain an 'arm's length' relationship between the buyer and the finance transaction, and to protect the rights of the buyer in the event of supplier insolvency prior to settlement, banks invariably require the supplier to sign a receivables purchase agreement (RPA).
 - The bank buys the receivable from the supplier under the RPA.
 - This process requires the cooperation of the supplier, inhibiting and delaying adoption.
 - In addition, the process is more complicated where the supplier is outside the UK.
- Debt capacity:
 - Payables finance programmes for MNCs involve significant unsecured credit limits.
 - These are technically undisclosed (preserving the arms-length nature of the finance) but nevertheless use the bank's overall credit appetite.
 - Faced with competing demands to write credit facilities to support other lines of business, the Payables Finance limits are often constrained, forcing the bank to collaborate with other banks.
- Complex distribution/syndication:
 - There are a number of collaboration options, all of them sub-optimal:
 - The 'lead bank' could host the whole programme on their own proprietary platform and execute funded risk distribution agreements with other banks. The bank acts as agent for the other banks with regard to the processing of advances and collection of payment from the buyer.
 - The client agrees to split the programme amongst several banks, each focusing on suppliers in markets where they have a presence and can undertake the on-boarding. The client has multiple platforms to interact with and multiple payables finance agreements to manage.
 - The banks agree to use a common third-party platform. This avoids the problem with multiple platforms, but still involves multiple payables finance agreements.
 - A non-bank FinTech hosts the programme and invites banks to become funders. This usually involves creation of an SPV.

Fig. 2 | trace:original makes the whole MNC Payables Finance process

much smoother and safer

SCENARIO 2 - MNC (Payables Finance)



trace:original solution

- Streamlined supplier onboarding:
 - Instead of getting an RPA signed by the supplier and taking an assignment of each receivable, a digital bill of exchange or promissory note can be used as the vehicle for acquiring the right to get paid.
 - Being digital the processes of issuing, transferring and presenting can be integrated into the workflow, making it much simpler for both buyer and suppliers.
- Simple distribution:
 - Accepted bills of exchange and signed promissory notes are negotiable so can be used in a secondary market.
 - A single bank can, therefore, manage a programme and then sell bills/notes to other banks or non-bank investors in the secondary market.
- Optimised debt capacity:
 - Use of bills of exchange as the basis for funded risk distribution optimises efficient use of credit limits.
- In essence, this would follow the same model as used in the forfaiting market albeit with digital instruments and an automated workflow.
- In this way, a bank or a FinTech can host a programme, simplifying operational processes for both buyer and suppliers, and other investors (bank and non-bank) can participate by buying the bills/notes in a secondary market.

MNC Receivables Finance

Problems

- Complex structuring and execution:
 - Programmes are usually described as 'non-recourse' in order for the client to achieve off-balance treatment.
 - Programmes are typically underpinned by credit insurance covering protracted buyer default or insolvency.
 - Legal due diligence required in both country where invoice is issued (to ensure a valid assignment can be perfected) and country where buyer is domiciled (to ensure that a receivable can be enforced).
 - Given that MNCs have operating companies in multiple jurisdictions, invoices are issued in multiple countries.
 - Buyers can be domiciled anywhere in the world.
- Risk mitigation:
 - Value of credit insurance as security is subject to contractual fulfilment by the client (if the buyer alleges contractual default by the client, the insurer will not pay). In such an event, the bank exercises recourse.
- Debt capacity:
 - Even though these facilities are described as 'non-recourse' credit limits are often booked against the client as well as the credit insurer:
 - This reflects the recourse conditionality (in the event that it is not possible to make a valid claim under the credit insurance policy).
- In most cases, the MNC acts as collection agent for the bank, exposing the latter to payment risk (a.k.a. transfer risk).
- Complex distribution/syndication:
 - Similar to payables finance, there are a number of collaboration options, all of them sub-optimal:
 - The 'lead bank' could host the whole programme on their own proprietary platform and execute funded risk distribution agreements with other banks. The bank acts as agent for the other banks with regard to the complex legal due diligence processes, the processing of advances, management of insurance cover and collection of payment from the buyers.
 - The client agrees to split the programme amongst several banks, each focusing on client subsidiaries or buyers in markets where they have a presence and can undertake the necessary due diligence. The client has multiple platforms to interact with and multiple RPAs to manage.
 - The banks agree to use a common third-party platform. This avoids the problem with multiple platforms, but still involves multiple RPAs.

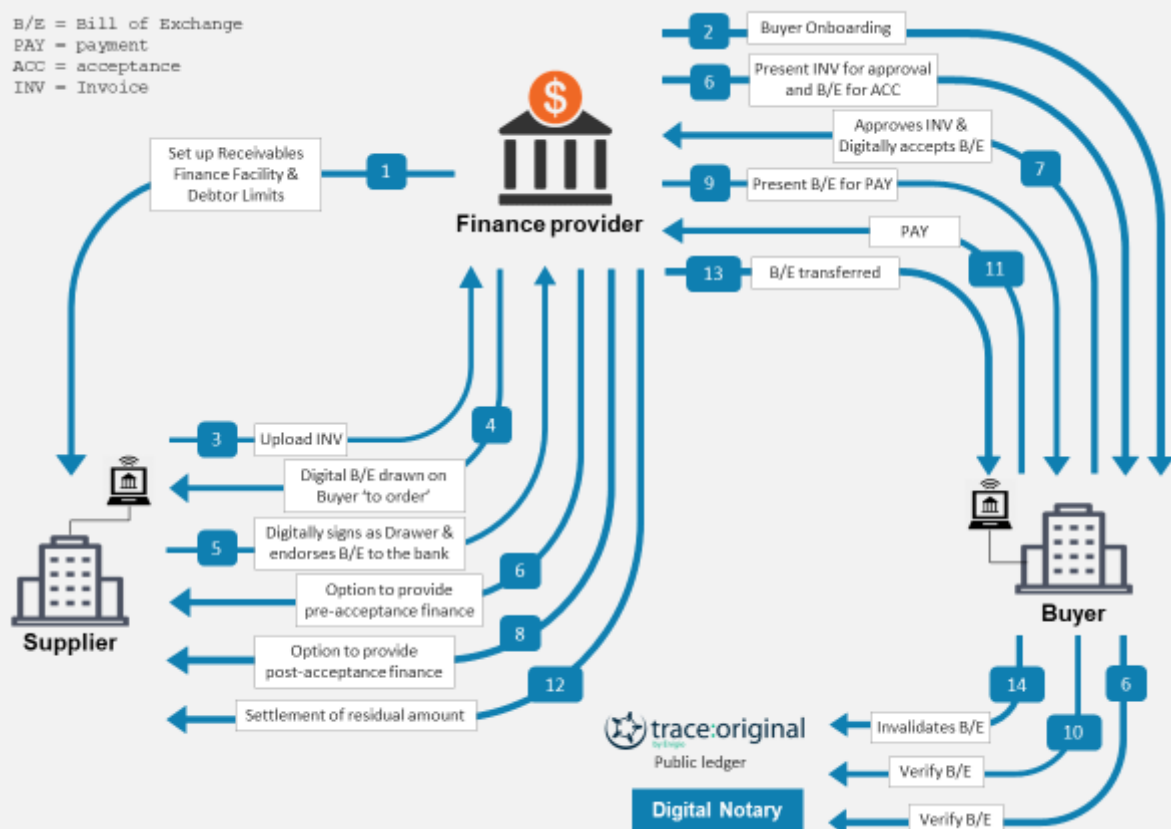
- A non-bank FinTech hosts the programme and invites banks to become funders. Each participant bank still has to undertake due diligence, so their participation is often restricted to markets where they have a presence. This usually involves creation of an SPV.

trace:original solution

- Streamlined structuring and execution:
 - Bill of exchange legislation exists in most countries, providing consistent and predictable interpretation of the rights of the bank as holder.
 - No need to take and perfect assignment of receivables countries where invoices are issued by client operating companies.
 - No need to ensure enforceability of assigned receivables in jurisdictions where buyers are domiciled.
- Enhanced risk mitigation:
 - Value of credit insurance is enhanced due to evidence of accepted bills and nature of bills of exchange as irrevocable, unconditional, independent payment instruments.
- Optimised debt capacity:
 - Using digital bills of exchange, true non-recourse finance can be provided upon acceptance by the buyer.
 - Streamlined collection of bill proceeds under the control of the bank is facilitated.
- Simple distribution/syndication:
 - Accepted bills of exchange and signed promissory notes are negotiable so can be used in a secondary market.
 - A single bank can, therefore, manage a programme and then sell bills/notes to other banks or non-bank investors in the secondary market.
 - In essence, this would follow the same model as used in the forfaiting market albeit with digital instruments and an automated workflow.
 - In this way, a bank or a FinTech can host a programme, simplifying operational processes for both buyer and suppliers, and other investors (bank and non-bank) can participate by buying the bills/notes in a secondary market.

Fig. 2 | trace:original makes the whole MNC Payables Finance process much smoother and safer

SCENARIO 3 - MNC (Receivables Finance)



Putting it all together

By looking at this from a joint and overall perspective it becomes apparent that the benefit matrix is very compelling:

Benefits to client and bank	SME & MidCap Exporters	MNC Payables Finance	MNC Receivables Finance
Generic advantages of trace:original documents over paper documents	✓	✓	✓
Access to finance	✓		
Operational efficiency	✓	✓	✓
Enhanced risk mitigation	✓		✓
Streamlined supplier onboarding		✓	
Simplified distribution		✓	✓
Optimised debt capacity	✓	✓	✓
Streamlined structuring and execution			✓



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Enigio offer solutions that ensure integrity and traceability of all your information to enable true and complete digital processes.

For more information, whitepapers and ways to contact us, please visit www.enigio.com.