International Chamber of Commerce
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Discussion Paper

Prepared by the ICC Commission on
Banking

The Bank Payment Obligation: Capital & Accounting Treatment

Prepared by the Commission on Banking's BPO Education Group

Highlights

- Accounting & Capital Treatment of BPO are both Evolving
- This Paper Offers Suggested Approaches to Guide Banks and National Regulators, to achieve fair treatment of the BPO
- While the BPO is a new Instrument, its Characteristics Mirror well-established Letters of Credit, and as such, Accounting and Capital Treatment can be Proposed Accordingly
- It is Imperative that this Paper Serve as Initial Input to an Ongoing Effort to Position the BPO Equitably, in terms of Capital Adequacy Requirements

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INTRODUCTION

This document is intended as an initial reference and guide for banks and other interested parties, related to the accounting and capital treatment envisioned by industry specialists, for the newly-created Bank Payment Obligation (BPO).

Banks issuing or receiving Bank Payment Obligations will be particularly interested, however, the following observations will be of value to banks considering adoption of the BPO in their trade and supply chain value proposition, as well as to corporate clients needing to understand the way their financial institutions will manage this instrument.

Capital and accounting guidelines and regulatory requirements can vary significantly across jurisdictions, and over time. Likewise, the interpretation and implementation of the proposed guidelines is also subject to variation; the following aims to propose a baseline set of suggestions and observations, which can form the basis of BPO accounting and capital treatment.

As the BPO is a new trade finance instrument, there are currently no official guidelines around accounting or appropriate capital treatment of this product. This document is a first step in articulating such guidelines, on the basis of expert and industry input. The following can serve as initial input to the deliberations of regulators, risk modellers and the Basel Committee among others.

Under current conditions in the global economic system, and with capital continuing to be a source of significant internal competition in banks across many parts of the world, fair and appropriate reflection of the risks and value of trade-related instruments such as the BPO must be of concern to trade bankers and their clients and business partners.

Proper accounting and the correct reflection of the capital efficiency of BPO, as a trade instrument, will ensure that banks opting to use this instrument within their trade finance portfolio of solutions can properly reflect and record the character and nature of BPO transactions for internal and external audiences.

The following discussion can be reviewed in conjunction with the ICC Uniform Rules for Bank Payment Obligations (URBPO), ICC Publication Number XXXXX, including Articles 3 and 4 which provide a comprehensive definition of the BPO.

DEFINITION OF THE BANK PAYMENT OBLIGATION

The Bank Payment Obligation (BPO) is a new instrument aimed at facilitating efficient and rapid settlement and financing of international trade transactions. The BPO is an instrument intended for use between banks, and the rules guiding BPO transactions are crafted accordingly.

A Bank Payment Obligation constitutes a legally recognized, binding and enforceable obligation of the Obligor Bank (that issues the BPO) to the Recipient Bank, as envisioned under the URBPO and as determined under appropriate standards of law in various jurisdictions.

The official definition[1] of the BPO reads as follows:

"A Bank Payment Obligation (BPO) is an irrevocable and independent undertaking of an Obligor Bank to pay or to incur a deferred payment obligation and pay at maturity a specified amount to a Recipient Bank in accordance with the conditions specified in an Established Baseline."

The BPO in Brief

The Bank Payment Obligation is designed, from a technology perspective, to be platform-agnostic: it can operate in a variety of environments, and can be created on the basis of data-matching processes using a variety of matching 'engines', hence the use of the generic term 'Transaction Matching Application' or TMA.

As the definition indicates, a BPO has several key characteristics as an instrument of international trade. The BPO is:

- Irrevocable, and as such cannot be unilaterally cancelled once issued
- Conditional, such that any financial obligation represented by the BPO is contingent in nature, requiring certain pre-defined conditions to be met before a financial obligation is created
- Issued for a single trade transaction and a specified amount

Each of the foregoing characteristics of the BPO implies specific accounting and capital treatment by banks using this instrument, and each element was intentionally included in the official definition of the Bank Payment Obligation for those reasons.

The Bank Payment Obligation has the characteristics and behaviour of any other contingent liability. As such, a BPO at the time of issuance is:

- Off-balance sheet for the Obligor Bank
- Unfunded

[1] This is the definition according to Draft 1 of the URBPO.

The execution of a BPO is contingent upon agreed transaction terms being fully met, as demonstrated by a complete match of data regarding the underlying trade transaction, between the Obligor Bank and the Recipient Bank. Specifically, the Transaction Matching Application generates a report, called a Dataset Match Report, which shows a perfect match between the relevant datasets. The datasets capture information about the commercial, transport, insurance or other data related to the sale of the underlying goods or services.

A BPO will not be executed if there is a mismatch in the data being compared through the TMA, unless the Obligor bank has accepted the mismatch.

The execution of a BPO is not, then, triggered by an event of default or non-performance, but rather by the sale of the underlying goods on agreed terms, as evidenced through a (successful) data matching process.

Upon the execution of a BPO for a payment “at sight”, the BPO will be utilized and is removed or liquidated from the books and balances of the Obligor and Recipient banks.
If the BPO results in a deferred payment undertaking, this obligation changes into a definitive undertaking at the time of a Dataset Match in the TMA, at that time, becoming an on-balance sheet undertaking.

A BPO cannot be “Confirmed” as is the case with a Letter of Credit. However, the Recipient Bank can incorporate a BPO into its agreements with the seller/exporter and can stipulate its behaviour in the event of receipt of a BPO. In this case, a BPO behaves the same for the Recipient Bank as for the Obligor Bank.

While the BPO and its related processes and rules (the URBPO) are bank-to-bank in nature, and therefore belong to the “Collaborative Space” between banks, any additional/separate agreement arranged between a bank and its client, such as between Recipient Bank and exporter, are in the “Competitive Space” between banks, and therefore not subject to the rules, guidelines and processes related to the BPO, such as the URBPO.

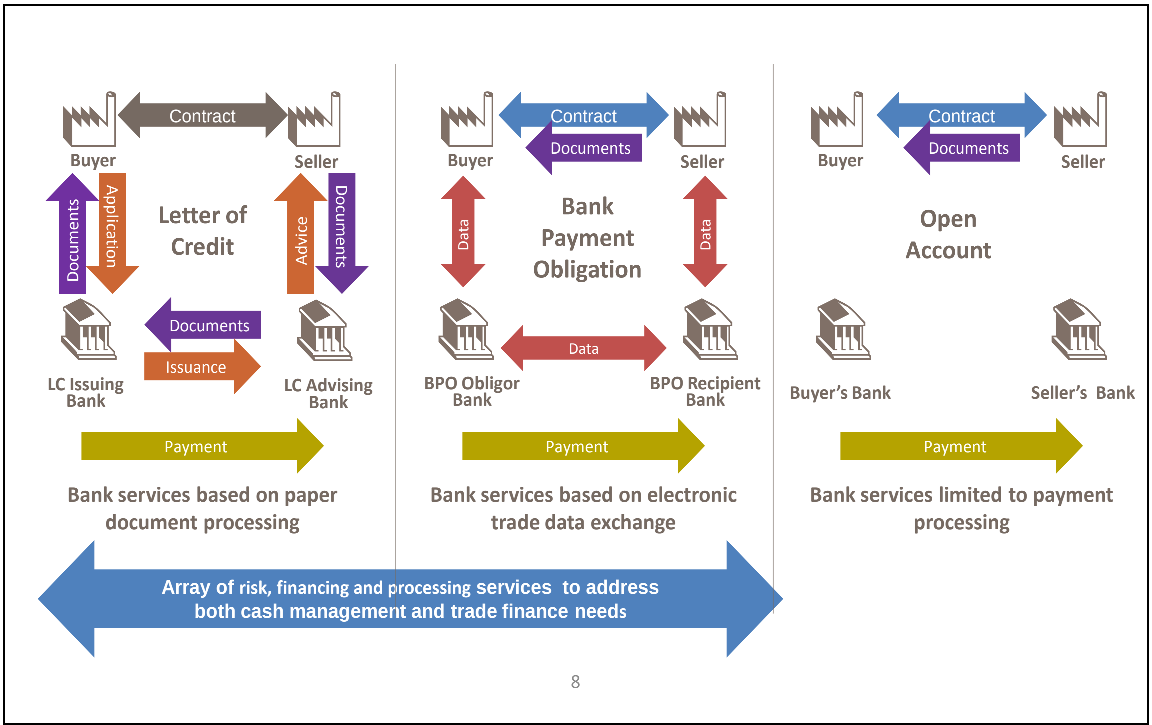
The Recipient Bank may issue a (contingent) undertaking to its customer based upon receipt of a BPO from an Obligor Bank; in this case, the following guidelines will assist the Recipient Bank in determining the appropriate accounting and capital treatment to be applied.

Accounting & Financial Reporting

The main issues to address in relation to proper accounting for a BPO transaction relate to:

- The nature of the instrument/obligation being accounted for
- The shift from one type/category of obligation (liability, for example) as the BPO transaction progresses, and the triggers for such shifts
- The nature or shift in obligation type, based on the parties involved in a given BPO transaction
- The appropriate offset of an accounting treatment at the close or maturity of a BPO transaction

For accounting and financial reporting/policy purposes, the issuance of a BPO should be viewed as similar to the issuance of an import letter of credit. These instruments behave quite similarly, and can be accounted for and reported in accordingly similar manner. The BPO is described as a payment risk mitigation and financing tool similar to a letter of credit while offering the efficiency of an open account transaction. Appropriate conservative treatment for accounting and compliance reasons suggests that the BPO be treated like an L/C.



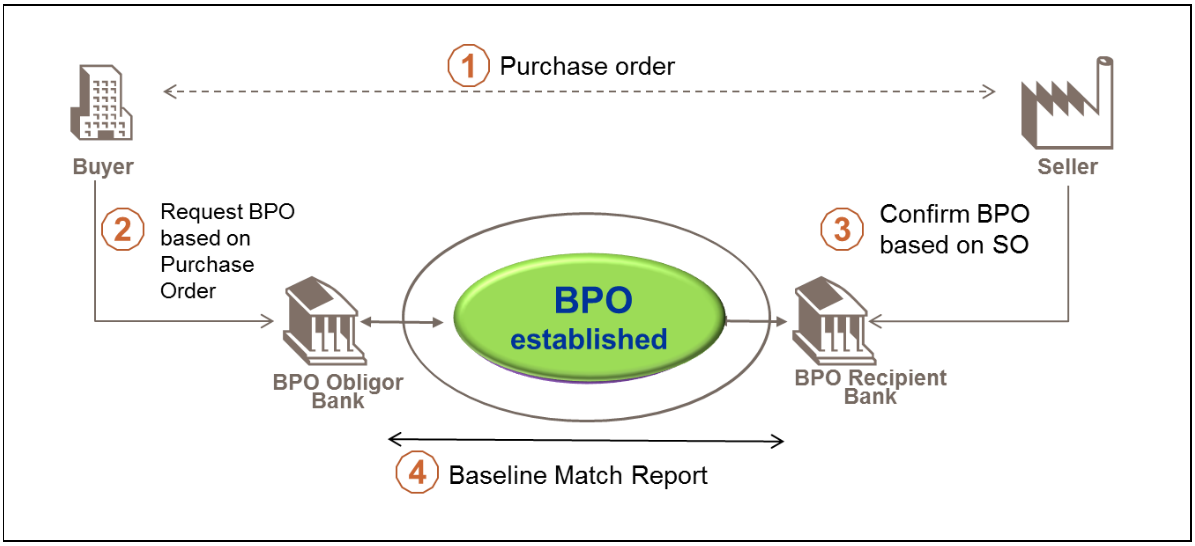
<u>Accounting treatment for the Obligor bank</u>

The BPO represents a primary payment obligation of the Obligor Bank.

Whenever the BPO Obligor bank(s), whether the submitting bank or any other obligor bank in the BPO transaction, are confirmed in their role of Obligor in an established baseline (successfully matched on TMA), then the Obligor bank(s) has(ve) a conditional obligation that represents a contingent liability that must be recorded off balance sheet.

Under a traditional letter of credit arrangement, once documents have been presented and no discrepancies found, the obligation of the Issuing/Confirming Bank ends in case of payment at sight, or becomes a direct liability in case of a deferred payment undertaking or an acceptance of a Bill of Exchange. It is then on balance, unfunded since no payment is effected yet.
If this undertaking or acceptance is discounted, the exposure becomes a cash item recorded as a loan/advance without recourse to the beneficiary, but under the framework of the letter of credit. At this point it moves from being an unfunded obligation to an actual funded obligation. So on balance and funded.

It is envisioned that the BPO should be treated similarly.



For a corporate customer, the exposure can either be disclosed or undisclosed.

Accounting treatment for the Recipient bank

One material difference between a BPO and a letter of credit is that the BPO is given by a bank (the Obligor Bank) in favour of another bank (the Recipient Bank), whereas the letter of credit is issued by a bank in favour of a corporate client – the exporter/seller and ultimate beneficiary. This difference means that in some cases, the BPO may need to be confirmed to the exporter/seller by the seller's bank (being the Recipient Bank).

As noted earlier, this event is outside of the scope of the BPO, and will form part of a separate agreement between a BPO Recipient Bank and its customer. In the terms of such an agreement, the Recipient Bank can issue another contingent obligation towards the seller, based on the BPO received. This can have the same effect as a Silent Confirmation of a letter of credit, and ought to be treated similarly from an accounting perspective.

Conclusion

Whilst the BPO is a new product and is different and distinct from a letter of credit, the above conclusions nevertheless reflect similarities to be found with the wording of UCP which states that an irrevocable letter of credit constitutes a definite undertaking of the Issuing Bank, provided that the stipulated documents are presented to the Nominated Bank or to the Issuing Bank and that the terms and conditions of the Credit are complied with.

Similarly, the Confirmation of an irrevocable Credit by another bank constitutes a definite undertaking of the Confirming Bank, provided that the stipulated documents are presented.

In the context of a BPO transaction, the BPO similarly constitutes a definite undertaking of the Obligor Bank, provided that the stipulated data matches successfully the established Baseline in the TMA.

Accounting treatment then, ought to be similar for the BPO as it is currently in the well-established world of the documentary letter of credit, with the various features and characteristics that run parallel between these instruments.

In many cases, the BPO will be issued by the Buyer's Bank. In those cases where the BPO has instead been issued by a third party bank (by which we mean, a bank that is not the Buyer's Bank at the time of issuance of the BPO) that bank's role is similar to that of a Confirming Bank under the traditional letter of credit model. That is to say, a financial undertaking is created, which is to be fulfilled provided that agreed conditions – data match with the Baseline in the TMA – are met.

Summary/Highlights of BPO Accounting Treatment

Party/Role	Liability Type	Period	Transaction Flow	Accounting Treatment
All Obligor Banks	Contingent	Between the establishment of the baseline and the successful match of the datasets	Confirming Obligor role in BPO	Off balance sheet Unfunded
Recipient Bank	Contingent	Between the establishment of the baseline and the successful match of the datasets	In case of "Confirmation" (in separate agreement with customer)	Off balance sheet Unfunded
Obligor Bank, Other Obligor Bank, and Recipient Bank (in case of "Confirmation")	End of liability	At the moment of payment at sight	Payment at sight after Dataset Match Report	End of liability
Obligor Bank, Other Obligor Bank, and Recipient Bank (in case of "Confirmation")	Direct	From the moment of Dataset Match Report till end of deferred payment period	Deferred payment undertaking after Dataset Match Report	On balance sheet Unfunded
Recipient Bank (in case of discount of Deferred Payment Undertaking without recourse)	Direct	From the moment of discount till end of deferred payment period	Discount of deferred payment undertaking	On balance sheet Funded

Conclusion

While the BPO is a new instrument in the business of trade finance, its fundamental nature and character is very familiar to bankers and trade financiers, with convenient and well-established reference points found in the long-established documentary letter of credit, its various features, and the ways in which it has evolved to meet a wide variety of needs for importers and exporters.

The novelty in the BPO from an accounting perspective, is that it is a bank-to-bank instrument; proper accounting for the BPO, which in the end supports a trade transaction, can be derived and understood with direct reference to the documentary letter of credit.

Capital Treatment & Regulatory Reporting

The regulatory context around banking and international banking in particular, has been growing more complex and more comprehensive for numerous years – a process that has been accelerated in the context of the global economic and financial crisis.

Capital adequacy and related reporting requirements have increased dramatically, and recent changes to the Basel framework have been quite unfavourable to the business of trade finance, with longer-term consequences of these unintended outcomes still unclear for the industry, for trade banking clients and for the conduct of trade across the globe.

Capital treatment, and the reporting thereof, has generally also been poorly understood across the industry, with the result that appropriate (previously significantly advantageous) treatment of trade-related obligations and liabilities has at times translated to a significant competitive advantage for banks that had understood and applied the appropriate capital treatment to their trade finance portfolios and businesses.

Within this context, it is deemed imperative that the Bank Payment Obligation is properly understood as a new instrument of trade finance, and appropriately and fairly handled from a capital adequacy and reporting perspective.

The BPO, as a new instrument, lacks the all-important portfolio history which is now at the core of capital adequacy models and which provides fundamental input into determining appropriate capital adequacy expectations various bank lines of business. Additionally, capital adequacy rules are promulgated as “soft law” by the Basel Committee, with actual regulatory standards ultimately set by national and regional regulators. Implementation of the new Basel rules is staggered globally, and as such, banks will also be at different stages in the implementation timeline, depending on their location.

Adequate guidelines and recommendations related to appropriate capital treatment and reporting around the Bank Payment Obligation will require commercial experience with the BPO. Given the role (and significantly different philosophies and standards) of national regulators, and the staggered timelines for implementation of the Basel regulations, such ‘live’ commercial transactions will be necessary to the proper articulation of capital adequacy and related reporting guidelines.

This Discussion Paper can be used to approach risk managers and risk modellers in banks involved in the BPO and their regulators, to assist in shaping equitable and adequate treatment of the BPO by all concerned parties and organizations. At a later stage, the Industry can approach the Basel Committee and other capital rulemaking entities (such as the European Union) once a reliable track record of BPO usage has been established and can be demonstrated.

Given that the BPO is, at its core, a contingent liability, it is of paramount importance that this instrument is qualified as an off balance sheet engagement, similar to a documentary letter of credit. Should the BPO for any reason whatsoever be treated as an on balance sheet engagement, the regulatory and economic capital to be set aside will be unnecessarily high, with very negative consequences for banking, trade finance and the trade-driven global recovery which many still foresee and hope for.

Capital adequacy and other regulatory pressures have already been shown to have very direct, negative impact on the availability of capital, risk appetite and pricing related to trade finance. While the industry has succeeded in mitigating some of the adverse effects of inequitable treatment of trade finance by regulatory authorities, there is still a net adverse impact from Basel II and Basel III, from which the industry has yet to recover.

The appropriate positioning of the BPO from a capital adequacy perspective is a matter of the highest priority for this new instrument of international trade finance.

As noted in the formal definition of the BPO, this instrument is a conditional obligation, and the execution of a BPO is triggered by the sale of underlying goods, rather than by any type of default or non-performance by a party to the transaction.

The Obligor bank has no duty to execute if the goods are not delivered, or if there is a mismatch between the Datasets and the Established Baseline mentioned in the Data Set Match Report.

There are several elements to consider in the context of capital adequacy and the reporting related thereto. The capital to be applied against a particular transaction or category of transactions is determined on the basis of several factors:

- The type of obligation or exposure
- Duration of exposure
- Leverage
- Likelihood of default and loss

The short-term, contingent and self-liquidating nature of traditional trade finance instruments, coupled with what was anecdotally known (and has since been demonstrated through industry data, in particular the ICC Trade Finance Default Register) to be a very low default and loss rate, have combined to support an argument in support of appropriate treatment of such trade finance instruments from a capital adequacy perspective.

The fundamentally consistent, even similar nature of the BPO to long-established traditional trade finance instruments argues strongly in favour of similar treatment of the Bank Payment Obligation.

The use of a Bill of Lading as a security
In Letters of Credit parties often refer to Bills of Lading as a security. For the Issuing Bank, a B/L can provide for some collateral in case the Applicant is in default. The Issuing Bank will then be able to recuperate the funds by selling the goods, in case

this is foreseen in a mutual agreement between the Applicant and the Issuing Bank, and in case the B/L was one of the documents required for in the Letter of Credit.
It seems that many banks have their own policies in how they will handle this kind of security. Some only value such a B/L in case of the trade of commodities, for example. Others consider the B/L as a comfort but not as a security.

A Confirming Bank will not handle title documents as a security, since they will, in most cases, not be a party (e.g. Consignee) in the B/L. Moreover, the outcome of trying to capture the relative goods in some remote port of destination is uncertain.

By nature, a BPO does not require the submission of documents for payment, so a B/L will not be integrated in this transaction.

An Obligor Bank however might choose to insert clauses in its mutual agreement with its customer (the Buyer) about the way the transport document (handled outside the BPO) or the relative goods might serve as collateral in a BPO, by incorporating a pledge agreement or the like.

As with Letters of Credit, these banks will have to look at their own policies to determine the way such securities are used to support their engagements.

As for Recipient Banks, “confirming” a BPO in their agreements with their customers/sellers the situation is similar than with a Letter of Credit. The Recipient Bank will, in most cases, not be able to use documents or goods as collateral.

Whether a bank chooses (or can) use a B/L as security under a BPO can have direct implications in terms of accounting and capital treatment. The policies of individual institutions will vary and should be reviewed to ensure consistent and equitable reporting and capital treatment.

BPO Capital Treatment and (Performance) Guarantees
The BPO should not be treated as a Guarantee (or Standby Letter of Credit), be it performance related or a payment guarantee, or others.
The main differences are that the execution of a Guarantee is triggered by a non-performance or a default in a (trade) transaction.
The execution of a BPO is triggered by a performance, being the shipment of the underlying goods as evidenced through a (successful) data matching process, which is a completely different situation.
The BPO is part of the trade cycle itself. One party delivers, and the other party pays by means of a BPO. This is not the case with a Guarantee.

Probability of Default (PD)
The PD is purely counterparty-driven, and is dependent from the financial status of the obligor. Therefore, the PD of a BPO issued by order of a specific party should not be different from other engagements or liabilities undertaken with the same specific party as obligor. The PD is dependent from the rating (internal or external) the bank has assigned to the obligor.

Loss Given Default (LGD)
In principle, this element is product driven.
Since there is no reliable track record available for the BPO, banks involved in issuing or receiving BPOs will be subject to what the Basle Rules call 'Internal Ratings Based Foundation'. In this regime, the LGD is determined by the rules, and is set at a fixed 45%.

It is possible that, after some time, banks will shift to the 'Internal Ratings Based Advanced' approach. This change will require banks to demonstrate a credible track record, or develop an expert model, approved by their regulator, to determine their own LGD. As said earlier, this is, for the time being, not possible for the BPO.

Accordingly, we propose to set the LGD for issuing a BPO or for 'confirming' a BPO at the predefined value of 45%.

Since this is an Off balance Sheet Undertaking (OBU), for the calculation of the Risk Weighted Asset, a Credit Conversion Factor (CCF) of 20% should be used for commitments with an original maturity up to one year and 50% for commitments with an original maturity over one year.

These levels are recommended, based upon current Basel guidelines as they apply to other off balance sheet undertakings such as documentary letters of credit.

Effective Maturity
Since October 2010, the Basel rules allow the effective maturity of a letter of credit transaction to be used with a minimum of one day, instead of the effective maturity with a minimum of one year.

Given that the BPO has the same objective and character as a letter of credit, this waiver of the one year maturity floor should be applied to the BPO as well.

Credit Conversion Factor (For Calculation of Leverage Ratio)
This element applies to the calculation of the Leverage Ratio.
Under Basel III, all OBUs are subject to a CCF of 100% for the calculation of the Leverage Ratio. This means that these off balance sheet items will be considered as on balance sheet items for 100% to calculate the Leverage Ratio.

The industry feels that this is unjust as far as letters of credit are concerned, since these off balance items cannot turn into on-balance sheet items because of an event of default or other events beyond control of the banks, but only by the presentation of conform documents relating to the underlying sale of goods or services.

Therefore the Industry, ICC and other bodies are advocating to bring down this CCF for letters of credit to 20%. It is self-evident that BPOs should be under the same regime if this CCF for of 20% is granted to letters of credit.

Summary/Highlights of BPO Accounting Treatment

Probability of Default	Loss Given Default	Effective Maturity	Credit Conversion Factor
Counterparty-driven	45% (Under IRB Foundation)	Effective maturity with minimum of 1 day (if agreed under same regime as Letters of Credit	For calculation of RWA: 20% up to 1 year 50% over 1 year For calculation of Leverage Ratio: 100%

Conclusion

Given the lack of historical data and commercial experience around a new instrument such as the BPO, the current discussion related to capital adequacy is framed almost entirely with reference to recent experience around traditional trade products.

Early engagement of the Basel Committee and national regulators, as well as other parties in a position to influence the application of capital rules to the BPO will be a key element of the ICC's and the industry's approach going forward.

The International Chamber of Commerce (ICC)

ICC is the world business organization, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world.

The fundamental mission of ICC is to promote trade and investment across frontiers and help business corporations meet the challenges and opportunities of globalization. Its conviction that trade is a powerful force for peace and prosperity dates from the organization's origins early in the last century. The small group of far-sighted business leaders who founded ICC called themselves "the merchants of peace".

ICC has three main activities: rules-setting, dispute resolution and policy. Because its member companies and associations are themselves engaged in international business, ICC has unrivalled authority in making rules that govern the conduct of business across borders. Although these rules are voluntary, they are observed in countless thousands of transactions every day and have become part of the fabric of international trade.

ICC also provides essential services, foremost among them the ICC International Court of Arbitration, the world's leading arbitral institution. Another service is the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice.

Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on vital technical and sectoral subjects. These include financial services, information technologies, telecommunications, marketing ethics, the environment, transportation, competition law and intellectual property, among others.

ICC enjoys a close working relationship with the United Nations and other intergovernmental organizations, including the World Trade Organization, the G20 and the G8.

ICC was founded in 1919. Today it groups hundreds of thousands of member companies and associations from over 120 countries. National committees work with their members to address the concerns of business in their countries and convey to their governments the business views formulated by ICC.

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Policy and Business Practices

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