



SOFR: Trade Finance Priorities

**DRAFTED BY: BAFT IBOR TRANSITION WORKING GROUP,
SUITABILITY OF RATES SUBGROUP**

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BAFT (Bankers Association for Trade & Finance) is an international financial services industry association, whose membership includes a broad range of financial institutions throughout the global community. As a worldwide forum for analysis, discussion, and advocacy in international financial services. BAFT's roughly 300 members provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide. BAFT members represent the leading providers of trade finance and payments services in the world.

This paper examines the impact of the transition from LIBOR on the trade finance and payments businesses, and concludes there is an imperative for a forward looking term rate to ensure the uninterrupted provision of financing to support cross-border trade.

INTRODUCTION

Trade flows are facilitated by the accessibility of trade finance, which assists buyers and suppliers to meet their domestic and cross border import and export finance requirements, risk mitigation and working capital requirements. Trade finance exposures are diverse in nature, but are typically shorter in tenor, self-liquidating, and exhibit different terms and payment patterns than other corporate banking products. Transactions have multiple counterparties across different client segments including consumers, small and medium sized enterprises (SMEs), local corporates, multinational corporations, financial institutions and government agencies. Trade is essential to GDP growth and supply chain sustainability globally. In 2019, global trade flows totaled \$18.1 trillion, with an estimated \$9.77 trillion of that sum comprised of bank intermediated trade.¹

USD is the world's most utilized currency for trade and accounted for 42.22%² of global trade activity in 2019. USD LIBOR is a widely used benchmark across the trade finance industry globally. Trade finance products broadly reference LIBOR term rates due to their transparency of pricing and certainty of interest costs, which is critical, especially for financing offered at a discount, where the value of the discount needs to be determined at the start of the

¹ICC 2019 Trade Register

²Based on December 2019 MT 103 and 202 messages exchanged on SWIFT.

transaction. Transparent pricing and interest cost certainty in advance using term rates is a key element to maintaining that dominance and minimizing disruption to trade flows.

As the market prepares to transition away from LIBOR to Risk Free Rates (RFRs) by the end of 2021, BAFT member institutions have been working steadily to prepare for the transition away from LIBOR. Given the scale of other banking products and services, to date, trade finance has received less focus. Given to the unique characteristics and requirements necessary for trade finance products to transition away from LIBOR, BAFT formed a global working group to assess and address the challenges that institutions will face as they transition to the Secured Overnight Financing Rate (SOFR) and other RFRs.

In March 2020, BAFT responded to the New York Federal Reserve's Alternate Reference Rate (ARRC) Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR.³ In the response to the consultation, we highlighted the trade finance industry's concern with a lack of forward term SOFR and encouraged the ARRC to develop a working group focused on trade finance to address issues specific to this subset of the banking industry. In the ensuing months, we have been pleased to see the formation of a SOFR Term Rate working group, and the publication of the Request for Proposals for a Term Rate administrator. We look forward to continued progress toward the publication of a forward-looking term SOFR in the first half of 2021 for use by the Trade Finance market.⁴ In the interim, we continue to encourage the ARRC to develop a working group focused on trade finance and to provide trade and working capital conventions and directions to the market early in 2021.

Though members have made progress in identifying areas where overnight SOFR could be used⁵, we believe the majority of transactions require a forward-looking rate to provide certainty to trade buyers and sellers. Establishment of a SOFR term rate and timing of its launch are critical for the trade market to finalize conventions and support the transition away from LIBOR. This was also recognized in the Sterling Risk Free Rate Working Group Use Case Paper published in January 2020.

This white paper is the culmination of several months of analysis by BAFT IBOR Transition Working Group members, as well as input revived from a global BAFT member survey⁶. The

³ BAFT's public response to the ARRC Consultation is available on the BAFT website.

⁴ ARRC 2020 Objectives. Request for Proposals

⁵ See Appendix 1: Assessing Term Rate Alternatives on page 11

⁶ BAFT surveyed its members on the impact of IBOR transition for Trade Finance. The survey was conducted from July 1 – July 10, 2020. Fifty-seven responses were received.

working group also considered findings from the BAFT Future Leaders' Group on IBOR Transition and incorporated elements of their work in this paper.⁷

In the pages that follow, we provide an overview of survey findings and highlight the breadth and depth of the impact that the transition to SOFR will have on trade finance products (specifically loan products and discounted products) and explain the rationale for the trade finance industry requiring forward-looking rates and credit premium transparency.

SURVEY FINDINGS

BAFT surveyed its member institutions in July 2020. Fifty-seven banks responded to the survey. Of the respondents 49% were North American headquartered institutions, 21% were headquartered in Western Europe, 16% in the Asia Pacific, 7% in Central and Eastern Europe, 3% in Africa, 2% in MENA, and 2% in Latin America. Of the banks surveyed, 45% had assets of over 1 trillion USD, 28% had assets between 250 billion and 1 trillion USD, and 27% had assets of less than 250 billion USD.

In order to assess the client composition of the respondent banks we asked that respondents identify the largest segment of their corporate client portfolio. Forty-one percent of respondents stated that the majority of their clients were multi-national corporations. Meanwhile, the other 49% of respondents were equally split between primarily serving Small and Medium Enterprises (SME) and Mid-caps.

Overwhelmingly, respondents cited internal challenges with the IBOR transition. The primary sources of the challenges stemmed from the current lack of a forward-looking term rate and an uncertainty that the timeline laid out for its possible development and implementation would be insufficient for the industry to transition seamlessly.

Members voiced a particular concern with trade finance transactions that are offered on a discount (interest deducted upfront) basis (e.g. supply chain finance), where the lender "buys" the receivable, less the discount cost. Businesses that rely on these products typically do not have access to market curves, are price sensitive and thus less suited to the compound in advance approach. For the lenders to be able to continue to offer this funding solution, widely relied on by many corporates globally, forward- looking term rates are essential (interest cannot be deducted upfront if it is not known at the time of funding and fixed through to the maturity). In addition, there is an active secondary market for trade finance assets, which

⁷The BAFT Future Leaders Paper is available on the BAFT website.

provides liquidity as well as risk mitigation and mostly replicates the methodology of the underlying asset being sold. Therefore, in the secondary market, if the underlying transaction is discounted, the sale between the existing financing party and the new party will also be discounted. In order for the secondary market to continue to function efficiently, both parties (often two financial institutions) need to be able to determine a mutually agreeable third-party rate to apply to the discount.

USD is the predominate currency used in trade transactions globally. The following sections provide an overview of the different types of trade finance products and the impact that transitioning to SOFR will have on each product type.

LOAN-TYPE AND DISCOUNTED TRADE FINANCE PRODUCTS

Traditional trade finance instruments provide risk mitigation to both sides of the transaction, providing buyers the confidence to know they will receive the goods purchased based on terms in a timely manner and for suppliers, payment credit enhancements. These include Supply Chain Finance, Documentary Letters of Credit ('LCs'), Collections, Bonds, SBLCs and Guarantees. These products offered collectively under trade finance are diverse, coinciding with the equally varied client base served. The extent of the impact of the transition to SOFR will depend on the type of product as well as the jurisdiction or the type of client involved.

• LOAN-TYPE TRADE FINANCE PRODUCTS

Loan type Trade products generally have specific, larger underlying principal amounts, longer tenor terms and commercial conditions that differ from shorter-term discount instruments and supply chain programs. Trade finance loan products include import and export loans as well as Export Credit Agency Loans that are supported by sovereign Export Credit Agency, ("ECA") credit support. These export credit agency loans, structured import and export finance trade loans, currently reference LIBOR when determining the rate applied. Clients utilizing a trade loan may be sophisticated borrowers (large corporate, banks, other financial institutions and government agencies) that require alignment between anticipated cash flows and derivative products to ensure effective and efficient hedging on these larger and longer-term transactions.

TABLE 1: LOAN-TYPE TRADE FINANCE PRODUCTS

<i>Characteristics:</i>				
<ul style="list-style-type: none"> Principal and interest payable on stated dates; the interest component is clearly stated Interest is payable in arrears (can be either at maturity or also at predetermined refi dates) Interest can be calculated on a backward-looking basis, but removes certainty for borrowers at the outset of the financing regarding how much interest they will be paying 				
	Trade Loans	Banker Acceptance (BA) Financing	Import Loans	Payables or Receivables-backed Loans
Trade Product Description	Number of clients (both corporates and correspondent banks) approach Bank for term trade loans These could be in form of import, pre shipment and/or post shipment loans Interest is payable on such trade loans at fixed pre-determined intervals (i.e. 3 / 6 / 12 months and longer tenors as warranted for commercial transaction) Principal amount will be repaid at final maturity			
Market Bench under current scenario	Client pricing: LIBOR plus spread Standard market LIBOR benchmark (for example overnight / 3 / 6 / 12 month LIBOR rates)			
Current Interest Calculation	LIBOR Based	Spread over LIBOR	Standardized and Published Tenors	360 Day Market Convention
Solution required	SOFR Rates – Arrears and Forward	Credit Premium/ Spread Adjustment (Static and Dynamic)	Standardized and Published Tenors	Liquidity in the market for assets and liabilities utilizing SOFR and Market conventions

Export Credit Agency (ECA) backed financing, such as the U.S. Export Import Bank (EXIM), is often used to cover longer-dated and emerging market related transactions. An ECA provides repayment guarantee to lenders for these transactions. ECA loans typically support the building and production for aviation, shipping, energy and infrastructure projects. Without these trade loans these large capital projects would be more difficult to plan and execute and would have an adverse impact to the underlying overall economy. To assist in the continued facilitation of these trade loans, a forward-looking term rate enables determination of the future interest payments and allows borrowers to plan their cash flows in advance of the due dates. In most cases the limiting factor is not the product, but the jurisdictions and types of borrowers involved. Such borrowers may not have access to derivatives markets to obtain forward rates, while advanced knowledge and certainty of principal and interest payments is a prerequisite. ECA lending and export/import finance currently utilize a forward-looking rate that is needed to continue to provide clarity for settlement regarding the payment of principal and interest, as well as hedging.

- **DISCOUNTED TRADE FINANCE PRODUCTS: PRIMARY ISSUE**

The most significant issue facing global trade as a result of LIBOR cessation and the potential lack of a forward-looking term rate is the impact on discounted trade products. A large number of trade finance products currently rely on a forward-looking term rate, which is transparent, observable and fixed for a defined period of time, for instance a 24-hour window. In trade transactions, there are often multiple parties involved, the buyer, supplier and the two counterparties' banks. In the absence of a transparent and observable forward-looking term rate, with the 24 hour fixed window, the banks in these transactions could be applying different rates. In a discounted trade finance product a bank provides cash flow to a supplier today, which is otherwise due to them at a point in time in the future based on the original terms of sale, and therefore, it is provided at a discounted value.

Trade payable and receivable discount financing products are usually initiated by larger corporate buyers and often geared towards helping to improve working capital efficiency of their SME corporate suppliers, who may be less sophisticated, often lack a dedicated treasury function and may have less capability to adapt their processes and technologies to handle the transition. While the suppliers may be smaller, the importance of these products and costs of using them upfront cannot be ignored. The discount is passed on to these smaller suppliers who pay a lower discount rate for an early payment option that if it were too costly, would not be a viable solution to improve their working capital.

The financing of account receivables in trade finance receivables products are often initiated by more sophisticated suppliers to receive early payment on their outstanding invoices to their customers (i.e. accounts receivables on the suppliers' balance sheet). The supplier sells a receivable or multiple receivables to a financial institution. The discounted cost of account receivable financing typically includes a reference rate component with such rate derived from the forward LIBOR curve, matching the financing tenor of the receivable being purchased, and therefore will be affected by the transition. A new forward-looking rate is required to avoid disruption in the flow of commercial goods and settlement of payments.

This calculation of the discount must be completed on the day that the money is advanced. Therefore, there must be a forward-looking rate to enable the calculation that is also observable and transparent to the parties involved so that the costs of utilizing this funding option are known to all parties and all parties can effectively manage their cash flows and working capital.

Discounted trade finance products have been specifically identified as a use case for which forward-looking term rates are required, as mentioned above due to the inability to discount cash flows with an in-arrears reference rate. The Sterling Working Group has been working with four administrators (FTSE Russell, ICE Benchmark Administration, Refinitiv and IHS Markit) on the potential methodologies to solve for Term Reference Rates (TRRs), which, whilst differing slightly on the approach, are all basing their assumptions on, or relying on, a combination of actual Overnight Index Swap (OIS) trade data, tradable quotes provided by market makers and OIS futures data.

The new reference rates in their current overnight form cannot be applied appropriately to the discount context, with the main affected areas of concern include how prices are established in commercial contracts between buyers and sellers and the legal aspect surrounding the agreements. The working group has concluded that a forward-looking term rate is required to replace LIBOR in order to enable these discounted products to maintain the characteristics that differentiate them from other loan-like trade finance products, and to ensure minimal disruption to capital flows that are facilitated by discounting.

TABLE 2: DISCOUNTED TRADE FINANCE PRODUCTS

<i>Characteristics:</i>			
<ul style="list-style-type: none"> • Principle amount payable on a fixed maturity date; no stated interest component • Interest is deducted in advance, i.e. net proceeds payable on financing date = principle amount minus discount calculation (can be straight discount basis or discount to yield basis) • Discount calculation has to be done at the outset based on a forward-looking term rate 			
	Trade Finance Payable (Buyer-Led)	Promissory Notes / Bills of Exchange	Trade Finance Receivables (Supplier/Seller-Led)
Trade Product Description	<p>Buyer issues Irrevocable Payment Undertaking (IPU) to pay on a due date creating an irrevocable legal, valid, and binding obligation.</p> <p>Based upon IPU, bank offers Supplier the option to receive amount early, at a discount.</p> <p>Bank collects the full value of the payment from the Buyer at maturity</p> <p>Disclosed to both parties: Buyer and Suppliers/Sellers</p>	<p>Undertaking of Buyer (or Buyer's Bank) to pay a fixed amount of funds on a due date</p> <p>Underlying obligation to pay is documented via negotiable instrument</p> <p>Bank pays net present value of the negotiable instrument upfront and recovers face value at maturity</p> <p>Disclosed to both parties: Buyer and Suppliers/Sellers</p>	<p>Supplier/Seller approaches their Bank to discount their trade receivables (pool or discrete structure) upon shipment of goods.</p> <p>Supplier sells to a Bank net Receivables/Invoices of goods & services that have already been provided. Bank purchases the Receivables. Supplier receives an early payment of the invoice's <i>discounted</i> net face value (NFV) upfront. At invoice maturity date, Supplier receives payment from their Buyers/Obligors and remits such payment to the Bank that has purchased the invoices.</p>



	Discount Period is usually based on a short-term tenor (t = up to 1 year)	Discount Period is usually based on a short-term tenor (t = up to 1 year)	Usually the program is undisclosed to the Buyers/Obligors. These receivables could be on open account basis in favor of its supplier Discount Period is usually based on a short-term tenor (t = up to 1 year)
Market Bench under current scenario	Client pricing: LIBOR plus Applicable Margin Interpolated LIBOR for the actual duration of the underlying trade receivables (for example 67 / 82 / 132 days) - thus need to interpolated LIBOR for the relevant period		
Current Interest Calculation	Net Proceeds = Invoice Face Value – Discount Discount = Net Face Value * (Reference Rate + Applicable Margin * (t / 360 days)) Reference Rate can be IBOR or the funding Bank's Cost of Fund	Net Proceeds = Invoice Face Value – Discount Discount = Net Face Value * (Reference Rate + Applicable Margin * (t / 360 days)) Reference Rate can be IBOR or the funding Bank's Cost of Fund	Net Proceeds = Invoice NET Face Value – Discount Discount = Net Face Value * (Reference Rate + Applicable Margin * (t / 360 days)) Reference Rate can be IBOR or the funding Bank's Cost of Fund
Solution required	Term Rate is required. Given the Bank advances Purchase Price on a discounted basis and gets paid in Net Future Value (NFV) at invoice maturity date, the Reference Rate has to be based on a forward-looking basis. The upfront discounting at the beginning of the period mechanism is what differentiates the product from other trade finance products with loan-like characteristics that has interest accumulating at the end of period.	Term Rate is required. Given the Bank advances Purchase Price on a discounted basis and gets paid in NFV at invoice maturity date, the Reference Rate has to be based on a forward-looking basis. The upfront discounting at the beginning of the period mechanism is what differentiates the product from other trade finance products with loan-like characteristics that has interest accumulating at the end of period.	Term Rate is required. Given the Bank advances Purchase Price on a discounted basis and gets paid in NFV at invoice maturity date, the Reference Rate has to be based on a forward-looking basis. The upfront discounting at the beginning of the period mechanism is what differentiates the product from other trade finance products with loan-like characteristics that has interest accumulating at the end of period.

CREDIT PREMIUM

The trade finance market requires more clarity on how to manage and apply a Credit Premium, (difference between SOFR Secured Rate and current LIBOR rate) to transition existing products and also clarity on whether new term rate solutions will contain a dynamic credit premium, especially for longer term facilities that are more likely to experience credit stress over the life of the transaction. Solving this is desirable on both sides of the transaction.

Educating the market on the need for a credit premium to transition existing assets from LIBOR to RFR's is important to ensure economic equivalence with the original transaction. LIBOR is sensitive to credit conditions, as it has a credit component that RFRs (or ARR) do not have. The significance of this aspect of LIBOR has been highlighted recently due to the impact that Covid-19 has had on the market. LIBOR and SOFR have diverged significantly due to the fact that LIBOR that is linked to bank credit has come under stress along with credit while SOFR that is not linked to bank credit has not.

Currently ISDA has decided upon a 5-year historical lookback calculation on LIBOR by tenor (ex. 1-month or 3-month) to create a credit spread adjustment to legacy transactions that are being transitioned from LIBOR to SOFR to make the two rates fungible, and we believe this solution could also be applied to trade products. This is an example of one market convention that has developed.

To assist with planning, trade finance market participants need clarity on whether future rates will contain a credit sensitive premium and consistency thereon. Our membership is aware that there are some preliminary solutions that are being worked on and were encouraged to see the Credit Sensitivity Work Group formed by the New York Federal Reserve in February. BAFT is investigating and educating its members on the current credit solution infrastructure within the market place as well as some of the promising solutions that are being worked on by vendors independently. Operationally accounting for an absence of a credit component would involve significant system and process change to the business. Adding this to the changes that will be required to tactically offer products ahead of the availability of term rates will be challenging. Having a dynamic credit spread that represents the true cost of credit built into the new rate would be ideal but our industry members would welcome any solution that could be leveraged.



CONCLUSION

The ARRC's Request for Proposal issued on September 10, 2020 for a forward-looking term rate administrator is a positive development. Completion is not expected until the end of Q2 2021, which poses market awareness and implementation timeline complications. The industry seeks a more timely solution that would allow for consistent treatment and transparency. For corporates that would have multi-currency facilities, the impact of a different calculation of Term Reference Rates (TRR) could cause issues, including for their treasury and accounting departments, including hedging activities thus overcomplicating further the use of trade products using new RFRs when they operate in more than one currency. Thus the need for other currencies to develop their own TRR ahead of the LIBOR transition.

BAFT would welcome the opportunity to join the ARRC term rate task force in order to ensure that issues specific to the trade finance industry are further addressed and analyzed by the ARRC. Furthermore, we would encourage the ARRC to develop a working group focused on trade finance and working capital conventions and to provide directions to the market early in 2021 to address issues specific to this subset of the industry. The industry would benefit from certainty from the ARRC on the development of a term rate and on how such a credit component would work.

APPENDIX I: ASSESSING TERM RATE ALTERNATIVES

Calculation Methodology	Mechanisms and Tools	How it works	Pros	Cons	Products
Compound Setting in Advance	<p>Last Recent - previous nonequivalent periods i.e. previous 30 days for next 90 days</p> <p>Last Reset - previous equivalent period i.e. previous 90 day for the next 90 days</p> <p>RFR Averages (SOFR/SONIA)</p>	Rate from the previous interest period is applied to the current interest period.	<ul style="list-style-type: none"> • Rate is known in advance • Can be implemented using existing computational infrastructure, can be utilized now • Low implementation cost • Compound rate is more accurate than simple interest • Can be explained to clients 	<ul style="list-style-type: none"> • Rate does not represent current interest period represents a previous period • Could be a hedging mismatch • Prepayment can be handled but is awkward • Asset-liability mismatch (syndicated loan market rejected) 	<ul style="list-style-type: none"> • Works with non-discounted products (LOCs, guarantees) • Problematic for discounting products given “Cons” noted to left
Simple Interest in Arrears	<p>N/A</p> <p>RFR Rates as basis</p>	Simple interest computation	<ul style="list-style-type: none"> • Easy to implement • Explained to clients easily 	<ul style="list-style-type: none"> • Rate not known in advance • Less precision • Slight hedge mismatch 	<ul style="list-style-type: none"> • Works for most products except discounted products.
Compound Setting in Arrears [citation: 2020 BAFT Future Leaders IBOR Transition p.18]	<p>Payment Delay: The interest payments are delayed by a certain number of days and are thus due a couple of days after the end of an interest period. The idea is to provide more time for operational cash flow management. However, in the last interest period, the interest payment is due after the repayment of the notional, which leads to a mismatch of cash flows and may be difficult to handle from an operational and credit risk perspective.</p> <p>Lockout or Suspension Period: In this option, the RFR is no longer updated (i.e. frozen)</p>	The rate is applied daily to both principal and interest accrued.	<ul style="list-style-type: none"> • Most precise calculation • Alignment with Derivatives • Most effectively hedged 	<ul style="list-style-type: none"> • Complicated to implement • High implementation cost • Decisions need to be made on which mechanisms work for which products • Rate is not known enough in advance. • Difficult to explain to clients. 	<ul style="list-style-type: none"> • Works for most products Except discounted products



	<p>for a certain number of days prior to the end of an interest period (lockout period). During this time, the RFR of the day prior to the start of the lockout period is applied for the remaining days of the interest period. Hence, the averaged RFR can be calculated a couple of days before the end of the interest period. However, the calculation of the interest rate might be considered less transparent for clients and more complex for product providers to implement. In addition, the option involves interest rate risk that is difficult to hedge due to potential changes in the RFR during the lockout period</p> <p>Lookback: The observation period for the interest rate calculation starts and ends a certain number of days prior to the interest period. As a result, the interest payment can be calculated prior to the end of the interest period. This option involves slightly increased interest rate risk due to changes in the yield curve over the lifetime of the product. However, there are ways to hedge this risk, if required.</p> <p>RFR Indexes (SONIA/SOFR)</p>				
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