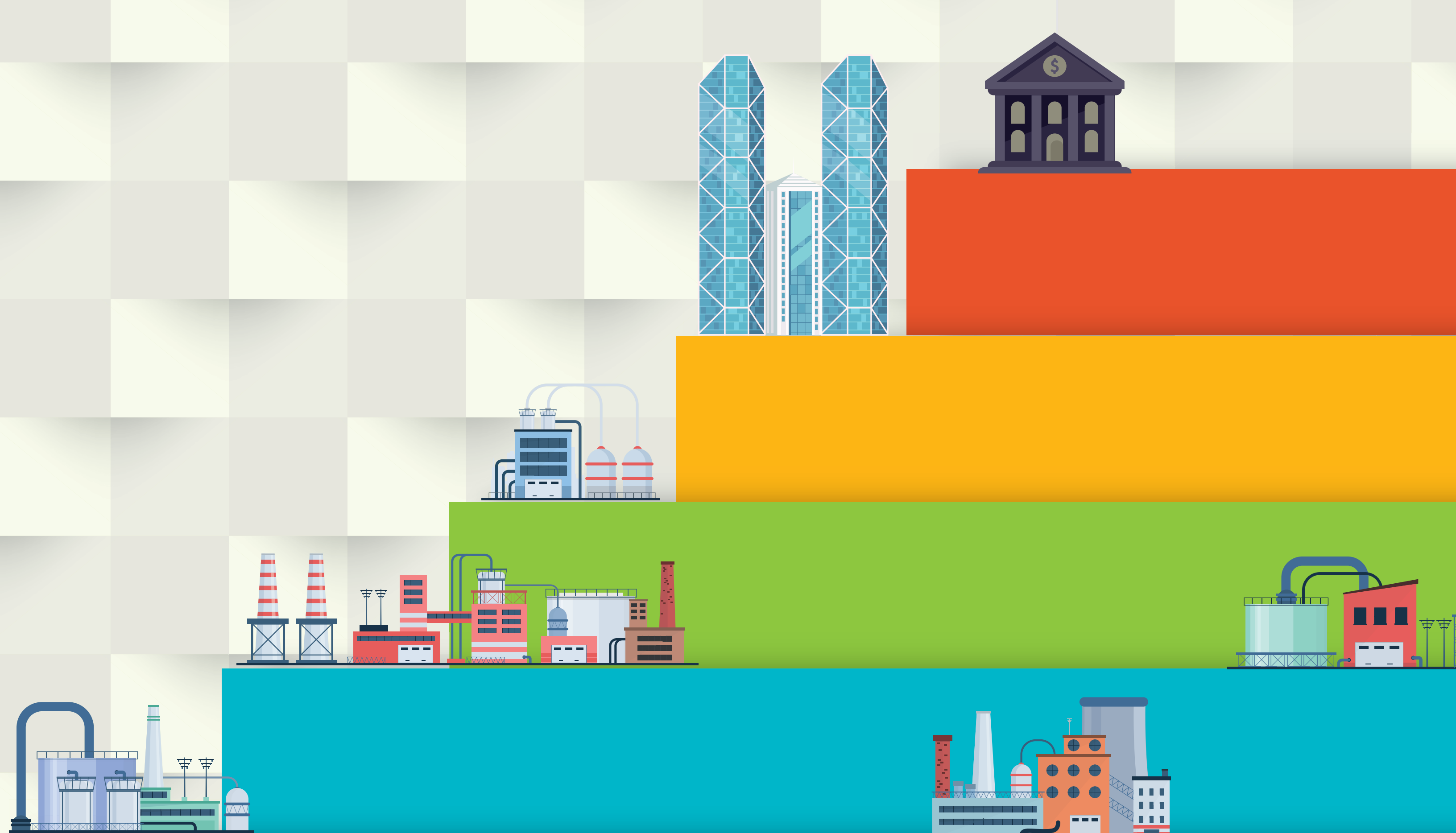

DEEP-TIER SUPPLY CHAIN FINANCE

UNLOCKING THE POTENTIAL

MAY 2024

BAFT

ADB

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ABBREVIATIONS

AML	–	anti-money laundering
DTSCF	–	deep-tier supply chain finance
ESG	–	environmental, social, and governance
fintech	–	financial technology
KYC	–	know-your-customer
MLETR	–	Model Law on Electronic Transferable Records
SCF	–	supply chain finance
SMEs	–	small and medium-sized enterprises
UNCITRAL	–	United Nations Commission on International Trade Law

EXECUTIVE SUMMARY

Why Is DTSCF Potentially Important?

Deep-tier supply chain finance (DTSCF) not only unlocks finance at favorable rates for deeper tiers in a supply chain, but it promotes an ecosystem of financial stability, risk management, and sustainability throughout the entire supply chain. DTSCF has the potential to reshape and strengthen traditional relationships by fostering more resilient; transparent; and environmental, social, and governance (ESG)-aligned trade relationships.

Why This Guidance Note?

In this guidance note, the Asian Development Bank (ADB) and BAFT (Bankers Association for Finance and Trade) offer perspectives on DTSCF, outlining its features as a new technique in financing trade and supply chains. The note also distinguishes what DTSCF is and does not aim to be while focusing on the necessary definitions and legal frameworks to enable its success at scale. The note highlights the potential of DTSCF to bridge the trade finance gap, drive liquidity to the most underserved segments of the trade market, and enhance visibility within global supply chains.

What Is DTSCF?

DTSCF is an innovative financial solution that has the potential to unlock financing for deeper tier suppliers where small and medium-sized enterprises (SMEs) are prevalent, as it allows access to finance by leveraging the credit risk of the anchor buyer. At the same time, DTSCF fosters transparency, helps stakeholders to understand their supply chains, and supports ESG initiatives and financing needs.

The note proposes the following overarching DTSCF requirements:

(i) **Financing:** must be financing related to a trade, i.e., trade finance.
(ii) **Financing method:** based on an irrevocable payment obligation of the anchor buyer.
(iii) **Structure:** post-shipment trade finance.
(iv) **Anchor buyer's supply chain link:** goods or services related to the anchor buyer's supply chain.

How Can DTSCF Be Scaled?

DTSCF stakeholders, including banks, nonbanks, and financial technology (fintech) companies adhere to a common characteristic: a platform-centric solution that facilitates connectivity and transparency over the anchor buyer's entire supply chain, along with the generation and processing of data.

Several factors require careful consideration when designing a scalable DTSCF solution, particularly in the context of cross-border trade. These include legal and regulatory aspects, currency considerations, and implementation challenges, such as limited adoption of technology by SMEs and the need for proactive engagement by the entire supply chain to fully unlock the potential of DTSCF.

This note provides guidelines on industry definitions and legal frameworks that can underpin success in scaling DTSCF. It addresses three key challenges to scaling: (i) increasing awareness and knowledge, (ii) fostering innovation and investing in technology, and (iii) promoting a legal framework for DTSCF.

I. INTRODUCTION

Deep-tier supply chain finance (DTSCF) not only unlocks finance at favorable rates for deeper tiers in a supply chain, but promotes an ecosystem of financial stability, risk management, and sustainability throughout the entire supply chain. DTSCF has the potential to reshape and strengthen traditional relationships by fostering more resilient; transparent; and environmental, social, and governance (ESG)-aligned trade relationships.

In this guidance note, the Asian Development Bank (ADB) and BAFT (Bankers Association for Finance and Trade) outline the features of DTSCF as a new technique in financing trade and supply chains. The guidance note distinguishes what DTSCF is and does not aim to be, while setting the necessary definitions and legal frameworks to enable its success at scale. The note highlights the potential of DTSCF to bridge the trade finance gap and drive liquidity to the most underserved segments of the trade market, while enhancing visibility within global supply chains.

Recognizing the potential for DTSCF to bridge the trade finance gap, ADB published a brief on DTSCF—the first of its kind—in 2022 at Global Trade Review (GTR) Asia, following which ADB and BAFT commissioned dedicated working groups to explore and provide recommendations on how to scale DTSCF.[1] Building upon ADB's brief and outputs from the working groups, this note delves deeper into the intricacies of DTSCF and provides industry guidance on what is DTSCF (and what it is not), along with the necessary definitions and legal frameworks to make it a success at scale.

This note is not intended to preclude the development of other forms of deep-tier finance, including the use of digital assets issued by financial institutions. The objective is to demarcate the various products for clarity among buyers, sellers, accounting and legal professionals, financial institutions, fintech companies, regulatory authorities, and other stakeholders in international supply chains.

A. Imperative

The coronavirus disease pandemic exposed the fragility and inefficiency of supply chains that span borders and industries. Recent macroeconomic developments and geopolitical tensions have exacerbated these vulnerabilities, adding to the complexity and fragility of global supply chains. Moreover, environmental impact, unequal distribution of economic benefits, human trafficking and exploitation, and the presence of human slavery and child labor in supply chains, have been brought into focus. In this evolving environment, innovative financial solutions for the often overlooked and vulnerable in society are essential to enhance overall supply chain resiliency. This includes an ability to respond effectively to unexpected developments and crises. Supply chains run deeper than just direct suppliers; the suppliers who operate in the deeper tiers of supply chains are critical to the existence of

[1] ADB. 2022. *Deep-Tier Supply Chain Finance. ADB Briefs.* No.129. Manila.

the supply chain and the production and delivery of final goods. Moreover, deeper-tier suppliers are now under more scrutiny as buyers are being held accountable by regulators, investors, and consumers for social and governance factors related to their entire supply chain. Suppliers located in the deeper tiers of the supply chain get the least financial support and are seldom the beneficiaries of traditional supply chain finance (SCF).

Financial innovation is important to address financing gaps, especially for small and medium-sized enterprises (SMEs). ADB's 2023 Trade Finance Gaps, Growth, and Jobs Survey estimates that the global trade finance gap reached $2.5 trillion in 2022, up from $1.7 trillion in 2020.[2] Although the backbone of most economies, SMEs are disproportionately affected by the trade finance gap, facing major challenges in obtaining the financing required to support their operations and grow to pursue opportunities in international markets.

The receivable purchase category of products within the domain of SCF, as defined by the Global Supply Chain Finance Forum, has received attention as a tool for improving access to finance at a lower cost, including for SMEs. This is done by shifting credit risk from the supplier to the anchor buyer.[3] Over the years, the benefits for both buyers and suppliers have been evident; it enhances cash flow management, mitigates financial risks, and offers more affordable financing options to suppliers. This nurtures a more resilient supply chain ecosystem.

B. Challenges

Although the receivable purchase category of products, especially payables finance, in SCF is frequently presented as the ideal solution to bridge SME financing gaps, it has not entirely fulfilled these expectations. Most global supply chains involve fewer SMEs in the first layer, as large buyers typically deal with more established names. tier-1 suppliers, which often began life as SMEs, have themselves grown, further reducing the presence of SMEs among direct suppliers to large global buyers. SME suppliers, due to their smaller scale and specialized role, are often found in the deeper tiers and are frequently overlooked. Therefore, SCF's receivable purchase category of product falls short in reaching SMEs. The challenges in overcoming these shortfalls are due to the following:

(i) **The focus on direct or tier-1 suppliers.** These are often relatively large firms with more robust financials and access to capital compared to SMEs.

(ii) **Cumbersome onboarding processes.** Scalability of seller or supplier-led offerings, such as factoring, are often hindered by onerous onboarding procedures. The cost and effort required to onboard suppliers, especially SMEs, can be prohibitive for lenders.

(iii) **Legal documentation.** The involvement of numerous stakeholders in different jurisdictions and the variety of regulations applicable to various SCF techniques add complexity, especially on perfection of assignment of receivables.

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2 ADB. 2023. *2023 Trade Finance Gaps, Growth, and Jobs Survey*. *ADB Briefs.* No.256. Manila.

3 The Global Supply Chain Finance Forum receivable purchase category, as defined in the *Standard Definitions for Techniques of Supply Chain Finance*, includes receivables discounting, forfaiting, factoring, and payables finance.

While the SCF offering has evolved over the years, unlocking financial support for deeper tiers of suppliers remains a challenge. DTSCF is one possible solution to address these challenges and unclog the flow of financial support to SMEs in supply chains.

C. Importance of Definitions and Fundamentals

As with any innovation, there has been a buzz in the market and a race among players to present a breakthrough in DTSCF. A variety of products with differing risk profiles are now being presented as DTSCF. A rudimentary scrutiny of these products shows that in many cases, the fundamentals of DTSCF, as defined by this note, are not present. This means the credit risk deteriorates as one penetrates the deeper layers.[4]

Most offerings inappropriately categorized as DTSCF are a collection of traditional trade finance offerings at each layer of the supply chain, i.e., the direct supplier to the anchor buyer, who becomes the buyer for the next layer in the supply chain, and so on. This structure leads to the credit risk moving from entity to entity, becoming progressively worse at each deeper layer of the supply chain. Similarly, some other offerings provide traditional purchase order finance products, i.e., a purchase order issued by a buyer at the top of the chain is presented as a low payment risk instrument through the supply chain based on historical payment trends in the supply chain.

Adherence to fundamental definitions and characteristics, as outlined in this note, is critical for successful DTSCF implementation and to lock the credit risk of the anchor buyer across tiers. Categorizing various deep-tier finance offerings with markedly different risk profiles leads to confusion, and potentially higher default rates, resulting from a worsening credit profile deeper in the supply chain. Therefore, differences between DTSCF and other deep-tier finance offerings should be clearly identified, understood, and communicated to avoid any reputational risk, which would impede DTSCF scaling.

The DTSCF framework in this note will guide the market in developing successful solutions, especially as it moves to cross-border transactions, not yet deployed as far as the authors are aware. Clear and standardized definitions and fundamentals will ensure that all stakeholders from businesses, financial institutions, and regulators have a common understanding, thereby reducing the potential for confusion and miscommunication. This may help regulators and policymakers create effective regulatory guidelines to ensure DTSCF is delivered in a legally sound and transparent manner. This is critical to maintain the stability and integrity of financial markets, and to scale DTSCF as an important innovation to bridge the trade finance gap and drive liquidity to the most underserved segments of the market, while enhancing visibility within global supply chains.

[4] DTSCF fundamentals are presented in section 2.2.1 (DTSCF Mechanism).

II. BUILDING THE FRAMEWORK FOR DTSCF

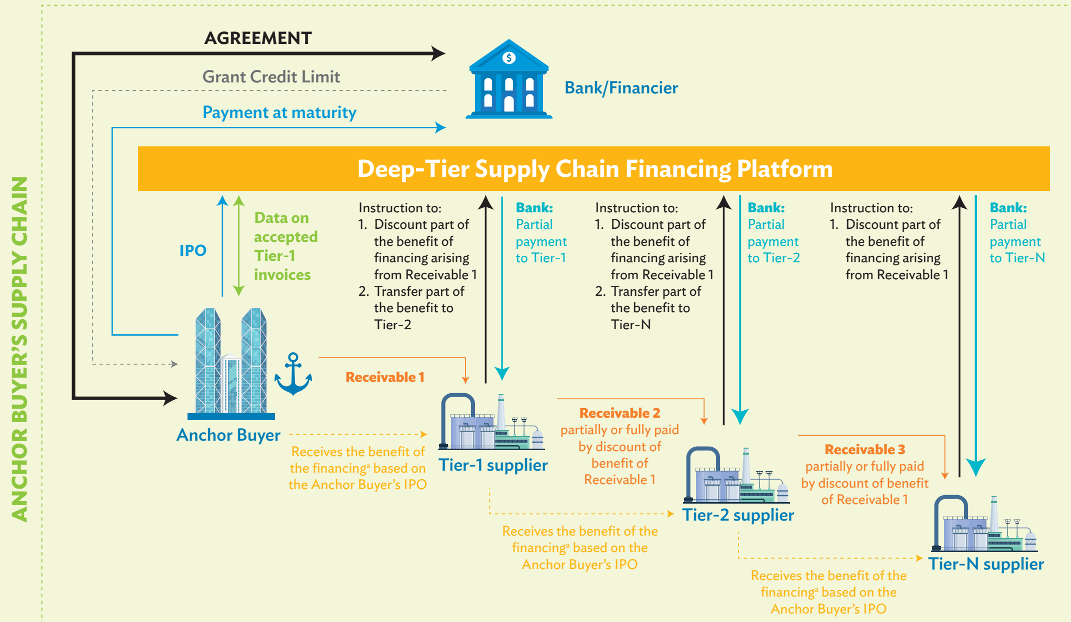
A. What Is DTSCF?

DTSCF refers to the series of post-shipment finance provided by the anchor buyer to its tier-1 supplier and between each consecutive tier, provided by the supplier (in its capacity as a buyer) to its corresponding supplier (e.g., a tier-2 supplier providing finance to a tier-3 supplier). The financing arrangements pertain directly to the supply chain and related goods and services of the anchor buyer. It allows anchor buyers to optimize their working capital by leveraging their payables financing programs to provide financing options for their tier-1 and non-tier-1 suppliers.[5] On the supplier side, it allows suppliers within the buyer's supply chain to receive the discounted value of receivables prior to their due date and typically at a financing cost aligned with the credit risk of the anchor buyer, which is often better. This enables suppliers to access affordable financing, improve cash flow, and increase transparency and efficiency throughout the supply chain (Figure).

DTSCF is premised on post-shipment finance to focus the credit risk on the anchor buyer, which usually has a better credit standing than its suppliers. In pre-shipment finance, consideration should be given to the performance risk of the supplier and such consideration is likely to affect the pricing of the financing. This falls outside DTSCF's core parameters, as proposed in this note and should be predicated on the anchor buyer's risk, not the supplier's risk. As one of the objectives of the working group was to clarify what DTSCF is (and what it is not), it was felt that post-shipment is an important parameter. Again, this is not in any way meant to be an impediment to innovation for pre-shipment financing. But to fully understand and appreciate the nuances between the different trade financing options, the differentiation of post-shipment financing is important. In fact, the information on SMEs provided by DTSCF could be used by banks to offer pre-shipment products to SMEs. The enhanced visibility, as well as performance information provided through DTSCF, could help foster additional assurance and confidence when taking on SME risk under a pre-shipment financing arrangement.

[5] Payables finance is described in GSCFF. *Standard Definitions for Techniques of Supply Chain Finance.*

General Flowchart—Deep-Tier Supply Chain Finance



IPO = irrevocable payment obligation.
[a] Priced based on the Anchor Buyer's credit risk.
Note: All parties enter into platform terms and conditions.
Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

B. Benefits by Stakeholder

The following table summarizes DTSCF's potential benefits per stakeholder.

Potential Benefits of Deep-Tier Supply Chain Finance

Anchor Buyer	**DTSCF has the potential to transform the anchor buyer's relationship with its suppliers and to become its preferred buyer** • Enhance resilience and transparency of supply chains • Enhance visibility to improve reporting and meeting ESG targets • Possibly extend financing terms with suppliers and improve cash flow • Improve supply chain resilience by relieving financial pressure on suppliers, providing access to finance at a financing cost aligned with anchor buyer's credit • Potentially reduce cost of goods sold with competitive funding rates • Reduce fraud and nonperformance risk from suppliers • Reduce operational costs
Suppliers	**DTSCF provides a lifeline of financial stability** • Access to finance at a cost aligned with the anchor buyer's credit risk • Reduce operational costs • Facilitate verification of compliance with ESG objectives

continued on next page

Table *continued*

Financiers	**DTSCF has the potential to unlock new business opportunities** • Expand client base by creating a new financial ecosystem • Mitigate credit risk in small and medium-sized enterprise offerings by transferring the payment commitment and credit exposure to the anchor buyer • Generate data that may help with financial and ESG risk assessment and management, mitigate other risks (such as fraud or double financing), and reduce operational costs and risk of errors • Gain a deeper understanding of client's supply chain requirements

DTSCF = deep-tier supply chain finance; ESG = environmental, social, and governance.

Source: Asian Development Bank, the Bankers Association for Finance and Trade and Simmons & Simmons JWS Pte. Ltd.

C. How to Efficiently Implement DTSCF

1. Mechanism

DTSCF is limited to a financing method that is coupled with an irrevocable payment obligation of the anchor buyer, which may be divided and transferred to the deeper tiers. As mentioned above, DTSCF is intimately linked to SCF's receivable purchase category of product and does not include other forms of finance, which may include loans to tier-2, tier-3, and beyond suppliers. This is based on information arising out of the anchor buyer's supply chain, e.g., purchase orders issued by the anchor buyer being linked to purchase orders issued by downstream suppliers. It is conceptually possible to split and transfer a key obligation used in SCF's receivable purchase category of product (the irrevocable payment obligation by the anchor buyer who presents the best credit risk profile in the entire supply chain) across multiple tiers of the supply chain. Alternative forms of deep-tier finance are likely to be based on the credit risk of the supplier at each tier (most of the time, a direct risk of the SME supplier, not the anchor buyer). This is the requirement that is proposed by this note as a formal definition of DTSCF, as they cannot unlock the benefits of divided and transferred irrevocable payment obligations flowing from tier-1 to tier-2 and beyond.

Therefore, DTSCF stands out compared to other forms of deep-tier finance because the credit risk does not deteriorate as financing extends to deeper tiers. The splitting and transfer of the irrevocable payment undertaking allows financiers to lock in the credit risk of the anchor buyer across the supply chain.

While there may be other approaches to providing financial support to multiple layers of suppliers in a supply chain, the working group has defined the following key overarching fundamentals or requirements for DTSCF:

(i) **Trade finance.** The financing should bear the key characteristics of trade finance, and therefore be related to the sale and purchase of goods and services, be short term, and be self-liquidating.

(ii) **Financing method with an irrevocable payment obligation of the anchor buyer.** The financing structure to the tier-1 supplier (the financing method)[6] and the corresponding nature of the irrevocable payment obligation of the anchor buyer must be such that the benefit may be divided

[6] The Financing Method was first introduced and is defined in ADB. 2022. *Deep-Tier Supply Chain Finance. ADB Briefs.* No.129. Manila.

and transferred to the lower tiers (the tiering method).[7] It is contemplated that the financing method will be payables finance as defined by the Global Supply Chain Finance Forum.[8]

(iii) **Post-shipment trade finance.** DTSCF should only refer to the provision of post-shipment (and not pre-shipment) finance at every tier. The provision of post-shipment finance does not need to be linked to the shipment of goods or provision of services that have already been received by the anchor buyer. Instead, it should be financing that is related to goods that have been shipped or services that have been performed in direct relation to the relevant anchor buyer in the supply chain. This is to ensure that only the anchor buyer's payment risk is assumed. The risk in DTSCF should not include any performance risk of the suppliers at any tier.

(iv) **Anchor buyer's supply chain.** DTSCF must pertain to the anchor buyer's supply chain and the financing should not be used for goods and services that are unrelated to the anchor buyer's supply chain (e.g., payment of rent for premises). This is to ensure that the risk profile of trade finance is maintained.

2. Legal Framework

Legal agreements and documentation are fundamental elements when designing the structure of DTSCF. A reliable legal framework that can be replicated provides clarity, legal protection, risk management, operational efficiency, and stakeholder confidence, facilitating a robust and scalable foundation for DTSCF. More information on the variety of agreements, risks, and mitigants, along with a summary of legal structures is available in Appendix 1 and Appendix 2.

[7] The tiering method was first introduced and is defined in ADB. 2022. *Deep-Tier Supply Chain Finance. ADB Briefs.* No. 129. Manila.

[8] Payables finance as defined by the GSCFF, not including variations (variations being confirming, dynamic discounting, or reverse factoring, which do not include an irrevocable payment undertaking from the anchor buyer).

III. CHALLENGES TO IMPLEMENTATION

A. Legal Considerations

Legal considerations center around the differences in legislation and regulations across jurisdictions. Varied regulatory frameworks create a complex mosaic of rules and standards that stakeholders exploring DTSCF must navigate. These considerations apply to the structure of the payment obligation, how financing is divided and transferred, dispute resolution mechanisms, know-your-customer (KYC), anti-money laundering (AML), and regulatory requirements, etc. To date, DTSCF does not exhibit a single legal structure, framework, or approach, either within or across jurisdictions.

DTSCF structures based on contractual rights in financing methods address considerations of enforceability but may limit the potential for scalability. To encourage wider applicability, consideration should be given to the choice of law and mode of dispute resolution that has a very wide global reach to be credible and effective. For example, dispute resolution via arbitration, enforced under the United Nations Commission on International Trade Law (UNCITRAL) Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention).

Structures using negotiable instruments in financing methods are constrained in jurisdictions that do not have legislation addressing legal recognition of electronic negotiable instruments, such as promissory notes or bill of exchange. Germany, Singapore, the United Kingdom, the United States, and six other jurisdictions have all adopted UNCITRAL's Model Law on Electronic Transferable Records (MLETR) or an equivalent legislation, so there is now increased momentum toward the harmonization of legal frameworks. The adoption of MLETR or equivalent legislation is fundamental, as it offers clarity on how conflicts of laws can potentially be addressed, thus decreasing uncertainty in cross-jurisdictional transactions.[9]

B. Currency Considerations

It is important to highlight that the cross-border nature of supply chains means additional considerations arise due to the involvement of different currencies, multiple jurisdictions, and regulatory controls.

(i) Cross-border exports by tier-1 suppliers are typically denominated in major international currencies such as United States dollar, euro, pound sterling, yen, renminbi, and Indian rupee, while sourcing from downstream suppliers (tier-2 to tier-n) may involve different currencies.

[9] The MLETR creates an enabling legal framework for paperless trade. It provides an international framework to align national laws to an extent and enables the legal use of electronic transferrable records both domestically and across borders by recognizing the electronic version of these instruments as equivalent to their paper-based counterparts. For more information on MLETR, see ADB. 2023. *Driving Digitalization of Global Trade: UNCITRAL Model Law on Electronic Transferable Records.* ADB *Briefs.* No. 280. Manila.

As we dive deeper into the supply chains, smaller suppliers often exclusively operate in their local currency, leading to currency mismatches that add to the complexity of DTSCF solutions.

(ii) Similarly, many emerging economies enforce foreign exchange control and other government policies that closely monitor export realizations or proceeds by exporters and import payment by importers through central banks. DTSCF may potentially impact these tracking mechanisms with receivables (or the right to receive payment) being tokenized or partially assigned down the chain. This complexity increases if such assignments involve foreign suppliers.

Therefore, it is crucial to involve regulators in the development of innovations such as DTSCF and to promote robust frameworks that can effectively regulate fast-evolving dynamics of international trade.

C. Operational and Technical Considerations

1. Limited Access to Technology

Despite the crucial role SMEs play in global supply chains, they often represent the most vulnerable link due to a high level of specialization and limited resources to address evolving market complexity. The primary focus on day-to-day survival, already constrained by a tight budget, is often prioritized over investing in technological advancements, creating a gap in SMEs' ability to adapt to modern supply chain demands and innovation. These challenges are exacerbated for SMEs in developing countries and/or remote areas.

2. The Need for Joint Ownership

DTSCF offers a win-win scenario for all stakeholders, including the financier, yet the party who initiates—the anchor buyer, bank, or supplier—is not always clear. This becomes particularly challenging for long tail supply chains, such as in the automotive industry. Like in an ESG initiative, it is not easy for one party to initiate the change, but it takes collaboration among all parties to make a change that would yield benefits to all.

Identification of key suppliers and their onboarding into the program is important and requires a joint effort from all stakeholders, likely led by the anchor buyer and/or the financier. This necessitates a high commitment from upstream suppliers as well, especially those in tier-1 and tier-2. This means tier-1 suppliers need to identify and facilitate onboarding of their suppliers, the anchor buyer's tier-2, and so forth. Hence, it is important to partner with committed suppliers who are willing to take an active role in the identification, education, and onboarding of respective suppliers.

3. Transferring Benefits Down the Chain

DTSCF relies on the willingness of the preceding tiers to pass on the benefit of the payment undertaking by further splitting and transferring down the chain. At any given tier, the supplier may choose not to exercise such a right and hold on to the full benefit transmitted by the previous tier. If the benefit fails to pass on to subsequent tiers, especially at tier-1 or tier-2, it completely undermines the purpose of DTSCF.

One potential solution is to integrate incentives into the DTSCF program, such as a framework where the previous supplier retains a minimum interest (incentive) if it transfers commensurate benefit to the subsequent tier. This is, however, for the anchor buyer and/or financier to assess when building program specifics.

4. Overcoming Information Barriers

A challenge in DTSCF may be the resistance from key suppliers, especially tier-1, to share details about their own supply chain and related commercial terms with the anchor buyer. This often comes from the fear that the anchor buyer might exploit the information to bypass its direct supplier (especially when there is no material value added from the tier-1 supplier) and engage with the tier-2 supplier directly. There might also be a concern around the use of information to gain negotiating power in commercial terms. The challenge lies in the complex and confidential nature of information sharing, which, paradoxically, is a key driver for the success of DTSCF. Without this data, the complete visibility necessary for effective implementation of DTSCF will remain out of reach.

Technology could help to ensure data integrity and transparency while providing permissioned access. It could also enable selective visibility, safeguarding sensitive commercial and transaction details while enabling the necessary transparency to provide understanding of the complete supply chain. Implementing a governance mechanism into the technology platform to define adequate rules, including encryption and/or regulating access to confidential information, may also be explored.

5. Supply Chain Linkages

While suppliers may serve several buyers, one of the key criteria of DTSCF is for the underlying goods or services to be related to one specific anchor buyer only. Given the extensive interconnections within supply chains, how does one prevent credit leakage, i.e., a payment undertaking of a financially strong buyer being used to finance trade in the supply chain of a weaker buyer? Establishing an effective protection against this is crucial to foster a reliable framework for DTSCF. Otherwise, the anchor buyer might lose interest in investing efforts to establish the program, as it may inadvertently confer improved business conditions to competitors. One potential solution is to leverage technology to trace end-to-end movement of goods, ensuring origin and end-use by one anchor buyer.

6. The Risk of an Adverse Domino Effect

If the potential DTSCF scale and penetration envisaged is achieved, there is a “domino effect” risk inherent in the structure. In the event the creditworthiness of an anchor buyer weakens or if the anchor buyer decides to discontinue the facility, this may have a significant impact on the supplier ecosystem. Unlike for an SCF offering, where only tier-1 suppliers (often stronger players with potential access to alternative financing resources) may be impacted, DTSCF spans beyond tier-1 to weaker companies, the SMEs. This may trigger a “domino effect” leading to a systemic impact on the market, including across sectors and/or industries, especially if financiers have built other financing products leveraging DTSCF flows.

Careful monitoring and control of the performance and strategy of an anchor buyer and dependency of suppliers on the anchor buyer are crucial to forecast and mitigate related risks. It is also interesting for the financier to see DTSCF as an opportunity to develop new market offerings for SMEs by leveraging the data provided by the DTSCF framework.

A summary of these challenges can be found in Appendix 3.

IV. TECHNOLOGY

Central to DTSCF is technology. As an emerging domain, DTSCF development will be influenced by ongoing exploratory efforts and pilots. These solutions share a common element: the adoption of a platform-based approach. The complexity associated with DTSCF, especially in reaching deeper tiers of suppliers, possibly located in different jurisdictions, demands a robust technology foundation. Technology will play a crucial role in facilitating identification, monitoring, and tracing of supply chain linkages. As mentioned above, fintech could play an important role in solving challenges to DTSCF by identifying the relevant ecosystem and in the strategic and controlled release of sensitive information along the supply chain.

In recent years, some fintechs have directed their efforts toward exploring technical solutions to implement DTSCF. However, they often face challenges in scaling a solution due to the lack of a reliable framework. Moreover, fintechs often lack the balance sheet to act as lenders or do not have sufficient reach to supply chain stakeholders. Despite the challenges, the industry remains keen to explore DTSCF solutions, sometimes with the support of financial institutions.[10]

[10] A technical overview of some DTSCF players can be found in ADB. 2022. *Deep Tier Supply Chain Finance. ADB Briefs*. No. 129. Manila.

V. DTSCF AS AN ESG ENABLER

In recent years, several ESG-related regulatory initiatives and guidelines have emerged across the globe, reflecting an effort to transition toward a more responsible and ESG-aligned global trade ecosystem.

Legislation requiring corporates to conduct due diligence on their supply chains has been passed in various jurisdictions. Following are some examples:

(i) **Australia:** Modern Slavery Act 2018[11]
(ii) **France:** Duty of Vigilance Act (Loi de Vigilance)[12]
(iii) **Germany:** Supply Chain Act (Lieferkettengesetz)[13]
(iv) **India:** Environment Protection Act 1986[14]
(v) **Indonesia:** Law No. 32 of 2009 on Environmental Protection and Management[15]
(vi) **Malaysia:** Environmental Quality Act 1974[16]
(vii) **Norway:** Transparency Act[17]
(viii) **Switzerland:** Articles 964j et seqq. Swiss Code of Obligations and the Due Diligence and Transparency Ordinance[18]
(ix) **Republic of Korea:** Framework Act on Sustainable Development[19]
(x) **United States (California):** Transparency in Supply Chains Act[20]

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15 Government of Indonesia. 2009. *Undang-Undang Republik Indonesia Nomor 32 Tahun 2009 Tentang Perlindungan Dan Pengelolaan Lingkungan Hidup Dengan Rahmat Tuhan Yang Maha Esa Presiden Republik Indonesia* (in Bahasa Indonesia); Asosiasi Pertambangan Batubara Indonesia. 2009. *Law of the Republic of Indonesia Number 32 Year 2009 Concerning Protection and Management of Environment* (In English).
16 Government of Malaysia, Department of Environment. 1974. *Akta Kualiti Alam Sekeliling 1974: ACT 127* (in Bahasa Malaysia); Government of Malaysia, Department of Environment. 1974. *Environmental Quality Act 1974: Act 127* (in English).
17 See footnote 13 (English version).
18 Government of Switzerland, The Federal Council. 2021. *Verordnung vom 3. Dezember 2021 über Sorgfaltspflichten und Transparenz bezüglich Mineralien und Metallen aus Konfliktgebieten und Kinderarbeit (VSoTr)* (in German); Government of Switzerland, The Federal Council. 2021. *Ordinance on Due Diligence and Transparency in Relation to Minerals and Metals from Conflict-Affected Areas and Child Labour* (in English).
19 Government of the Republic of Korea, Korean Law Information Center. 2022. *Framework Act on Sustainable Development.*
20 Department of Justice, State of California. *SB 657 Related Code Sections | State of California - Department of Justice - Office of the Attorney General*. Various ESG laws are in force in some states of the United States.

These legislations impose mandatory human rights, child labor, and/or environmental due diligence for companies in the anchor buyer's supply chains.

It is important to note the recent establishment of the International Sustainable Standards Board, a climate component of the International Financial Reporting Standard, which marks a significant shift toward standardized global sustainability reporting standards. This move is expected to be a major driver in supply chain monitoring, encouraging companies to align with standardized ESG reporting frameworks, and enabling stakeholders to make informed decisions based on comparable sustainability data.

DTSCF could serve as an effective tool to enhance visibility for reporting purposes (including for regulatory compliance) and to promote meeting ESG targets:

(i) **Environment.** Anchor buyers could use DTSCF to encourage (and incentivize) meeting ESG targets, e.g., via more favorable financing rates linked with ESG-aligned key performance indicators (KPIs). Anchor buyers could also leverage enhanced visibility to improve reporting as well as to optimize logistics, reduce lead times, and lower its carbon footprint.
(ii) **Social.** Anchor buyers could use DTSCF to enhance visibility and promote better labor standards within their supply chains by establishing KPIs related to fair wages and safe working conditions for employees.
(iii) **Governance.** Anchor buyers could gain more visibility over their suppliers' adherence to operational, ethical, and legal standards and/or practices.

With increasing market and regulatory demands for ESG reporting, DTSCF could be a useful tool for monitoring and promoting ESG-aligned practices. If the anchor buyer decides to incorporate DTSCF into a company's ESG strategy, it will require a holistic approach and the collaboration of all relevant stakeholders. It is important for anchor buyers to work closely with their suppliers, set clear ESG targets, and monitor progress regularly. It would be helpful to collaborate with financiers to include incentives, such as differentiated rates, within the scope of DTSCF. Effectively managed, DTSCF can emerge as a significant tool for ESG reporting, monitoring, and enhancement.

VI. CONCLUSION

A. Call to Action and Next Steps

While this note provides foundational pillars, the actual development of DTSCF demands joint action from all stakeholders. This call to action to unlock DTSCF's potential includes the following:

(i) Establish a forum dedicated to convening stakeholders to coordinate action to scale DTSCF and realize its full potential.
(ii) Create working groups to do the following:
  (a) Advocate for an enabling legal framework and urge governments to harmonize domestic legislation with international best practices, such as the MLETR.
  (b) Share insights on legal structures and requirements for effective implementation.
  (c) Clarify KYC and AML requirements.
  (d) Develop educational materials and foster partnerships across sectors to enhance understanding of DTSCF's potential.
  (e) Foster partnerships, collaboration, concepts, and pilots in fintech for DTSCF.
  (f) Standardize legal documentation.

In summary, stakeholders need to engage in open communication, collaborative efforts, and knowledge sharing to address the operational, technological, and legal challenges required to realize DTSCF's full potential.

B. Summary and Conclusions

Amid the prevailing challenges resulting from the pandemic, exacerbated by recent macroeconomic developments and geopolitical tensions, the imperative to make supply chains more resilient, inclusive, transparent, green, and socially responsible is evident. DTSCF not only unlocks finance at favorable rates for deeper tiers in a supply chain, it promotes an ecosystem of financial stability, risk management, and sustainability throughout the entire supply chain. DTSCF has the potential to reshape and strengthen traditional relationships by fostering more resilient, transparent, and ESG-aligned trade relationships.

DTSCF serves as a solution to provide access to financing to deeper tiers within supply chains where SMEs are prevalent, and by offering favorable financial rates based on the anchor buyer's credit rating, it could improve supply chain resilience. By leveraging enhanced transparency, monitoring, and traceability, DTSCF can also help to encourage meeting ESG targets while supporting reporting and compliance with upcoming ESG-related regulatory requirements.

Given its transformative potential, the market has seen various offerings inappropriately categorized as DTSCF that do not align with the fundamentals outlined in this note. This warrants caution due to the differences between the credit risk profile of DTSCF and other financial products. This note underscores the importance of establishing a reliable and scalable framework to ensure that the anchor buyer's supply chain can access financing and effectively benefit from its relatively better credit risk.

This note includes a call to action and offers the next steps required to overcome legal, regulatory, technological, and educational challenges impeding DTSCF's full potential.

APPENDIX 1

LEGAL AGREEMENTS AND DOCUMENTATION

Platform Terms Issued by the Platform Provider

The models that have been adopted by platform providers are varied, some more complex than others.

This note will not go into detail regarding the role of the platform provider, which plays a facilitative as opposed to a principal role in deep-tier supply chain finance (DTSCF). That is not to say that the platform provider does not play a critical role but more that the role it plays is amorphous and there is an interplay with the different structures discussed in this note. It is possible that the platform provider may enter into the agreement with the buyer and/or suppliers and some of the key provisions set out in the paragraphs below will be incorporated in the platform terms.[1]

Agreement between the Buyer and Financier

A financier, which may be a bank or platform provider, will enter into an agreement with the anchor buyer. This agreement should include the following key provisions:

(i) An irrevocable payment obligation of the buyer to pay the financier on the maturity date of the receivable. The irrevocable payment obligation may be in the form of a
   - (a) contractual right;
   - (b) negotiable instrument; or
   - (c) token representing (1) the right to claim and/or enforce the buyer's irrevocable payment obligation up to the value of the token; or (2) ownership (beneficial ownership from an English law perspective) of part of the receivable owed by the buyer to the tier-1 supplier up to the value of the token.

(ii) The buyer's consent, expressly or impliedly, to the division and transfer and/or assignment of the benefit of the irrevocable payment obligation.

[1] The agreements and considerations with respect to the Platform Provider have been coupled with that of the Financier to keep the simplify the deliberations.

Agreement between the Financier and Tier-1 Supplier

The agreement between the financier and tier-1 supplier should include the following provisions depending on the structure:

(i) Receivables purchase agreement between tier-1 supplier and financier for an assignment of rights (or transfer of title or the equivalent) to the whole receivable and/or asset being financed, according to the laws of the relevant jurisdictions:
  - (a) retention of part of the purchase consideration for payment to tier-2 supplier and onward;
  - (b) payment instructions for the tier-2 supplier and tier-n supplier will provide the relevant payment instructions down the supply chain; and
  - (c) know-your-customer (KYC) aligned with the Wolfsberg Trade Finance Principles 2019 Amendment.[2]

(ii) Receivables purchase agreement between tier-1 supplier and financier for an assignment of part of the rights (or transfer of title or the equivalent) to the receivable and/or asset being financed, according to the laws of the relevant jurisdictions for
  - (a) payment of purchase consideration for part of the receivable and/or asset; and
  - (b) KYC aligned with the Wolfsberg Trade Finance Principles 2019 Amendment (footnote 2).

(iii) Negotiable instrument purchase agreement between tier-1 supplier and financier for purchase of negotiable instrument(s) representing the buyer's irrevocable payment obligation on the maturity date for
  - (a) retention of part of the purchase consideration for payment to tier-2 supplier and onward;
  - (b) payment instructions for tier-2 supplier and tier-n supplier will provide the relevant payment instructions down the supply chain.

(iv) Negotiable instrument purchase agreement between tier-n supplier and financier for purchase of negotiable instrument(s) representing the buyer's irrevocable payment obligation on the maturity date on the assumption that the receivable represented by the negotiable instrument has already been divided and transferred.

(v) Token purchase agreement between tier-n supplier and financier for purchase of token(s) representing either
  - (a) the right to claim and/or enforce the buyer's irrevocable payment obligation up to the value of the token; or
  - (b) ownership (beneficial ownership from an English law perspective) of part of the receivable owed by the buyer to the tier-1 supplier up to the value of the token on the assumption that the right to claim and/or enforce (or the receivable represented by the token has already been divided and transferred.

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2 Appendix IV: Open Account Page 69 to 79 in The Wolfsberg Group, ICC, and BAFT. *Trade Finance Principles —2019 Amendment.*

Agreement between the Tier-1 Supplier and Tier-2 Supplier

The agreement between the tier-1 supplier and the tier-2 supplier should include the following provisions depending on the structure:

(i) Sale and purchase of goods and/or services pertaining to the buyer's supply chain.
(ii) Consideration to be paid by the tier-1 supplier to the tier-2 supplier will be in whole or in part for
  (a) an assignment of the right to receive payment from the buyer, which the financier is willing to finance as it has the contractual benefit of the irrevocable payment undertaking;
  (b) an assignment of part of a receivable due from the buyer;
  (c) a negotiable instrument representing the buyer's obligation to pay a sum on the maturity date; and
  (d) a token representing (1) the right to claim and/or enforce the buyer's irrevocable payment obligation up to the value of the token; or (2) ownership (beneficial ownership from an English law perspective) of part of the receivable owed by the buyer to the tier-1 supplier up to the value of the token.

Agreement between the Financier and Supplier

The agreement between the financier and the supplier(s) should include the following provisions depending on the structure (payment method):[3]

(i) payment instructions arising from a first level receivable purchase: depending on the platform terms, which may incorporate payment terms, possibly no agreement save for exclusions of liability for non-payment due to operative sanctions;
(ii) payment of purchase consideration: for part of the receivable and/or asset;
(iii) negotiable instrument purchase agreement; and
(iv) token purchase agreement.

[3] The Payment Method was first introduced and is defined in ADB. 2022. *Deep-Tier Supply Chain Finance.* *ADB Briefs*. No. 129. Manila.

Risk and Mitigants

Table A1: Risk Mitigants

Risks	Mitigants
Enforceability risks	• Analysis of the drafting and enforceability of the anchor buyer for the irrevocable payment obligation. • Analysis of assignment of part of receivables in the relevant jurisdictions including each supplier's jurisdiction and each supplier's jurisdiction in relation to the financier and/or platform provider. • Analysis of the negotiable instruments law including conflicts of laws. • Analysis of laws in relation to tokens and tokenization. • Applicability of electronic contracts and electronic signature laws in the relevant jurisdictions.
Credit and country risks of the buyer	• Credit and country risk assessment on the anchor buyer. • Low default rate of trade finance transactions.
KYC, AML, and sanctions risks	• Onboarding of the anchor buyer. • Depending on the level of instructions from and contractual relationship with the tier-2 /tier-n suppliers, KYC and/or AML onboarding may not be required, subject to local regulations. • Payment screening when payment is made to the suppliers may be required.
Disputes between buyer and tier-1 supplier and between suppliers	• Provisions in the platform terms that all disputes in respect of the underlying transaction shall be resolved between the parties accordingly outside the platform. • Ongoing commercial relationships between the parties in an existing supply chain.
Insolvency of platform provider	• Payments may be made directly from bank to supplier and by anchor buyer directly to bank with fees paid to the platform provider separately.

AML = anti-money laundering, KYC = know-your-customer.

Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

APPENDIX 2
LEGAL STRUCTURES

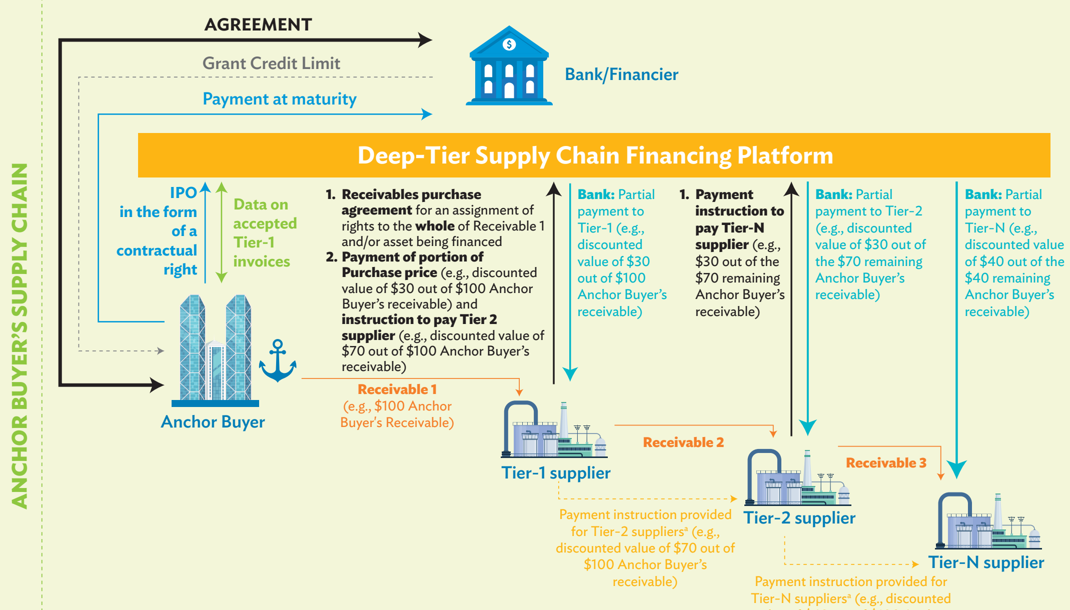
Table A2: Summary of Legal Structures

Structure	Financier and Buyer	Financier and Tier-1 Supplier	Financier and Tier-n Supplier	Tier-n Supplier and Tier-n+1 Supplier Purchase Considerations	Issues
IPU - Contractual Right	Irrevocable payment obligation and/or undertaking	RPA to purchase whole receivable	Payment instructions	Payment from financier	• Link of supply to the anchor buyer • Analysis of the drafting and enforceability of the anchor buyer for the irrevocable payment undertaking
		RPA to purchase part of a receivable	RPA to purchase part of the receivable due from anchor buyer	Assignment of part of receivable due from anchor buyer	• Link of supply to the anchor buyer • Assignment and sale of part of receivable across various jurisdictions
Negotiable Instrument	Duly accepted and negotiated NI	NI purchase agreement (NI representing the whole amount)	Payment instructions	Payment from financier	• Link of supply to the anchor buyer
		NI purchase agreement (NI divided and transferred)	NI purchase agreement	Negotiation of NI accepted by buyer	• Link of supply to the anchor buyer • Conflicts of laws in respect of NIs
Token	Token (see paragraph 2 of Appendix 1 in *Agreement between the Buyer and Financier*)	Token purchase agreement	Token purchase agreement	Token	• Analysis of laws in relation to token and tokenization

IPU = irrevocable payment undertaking, NI = negotiable instrument, RPA = receivable purchase agreement.

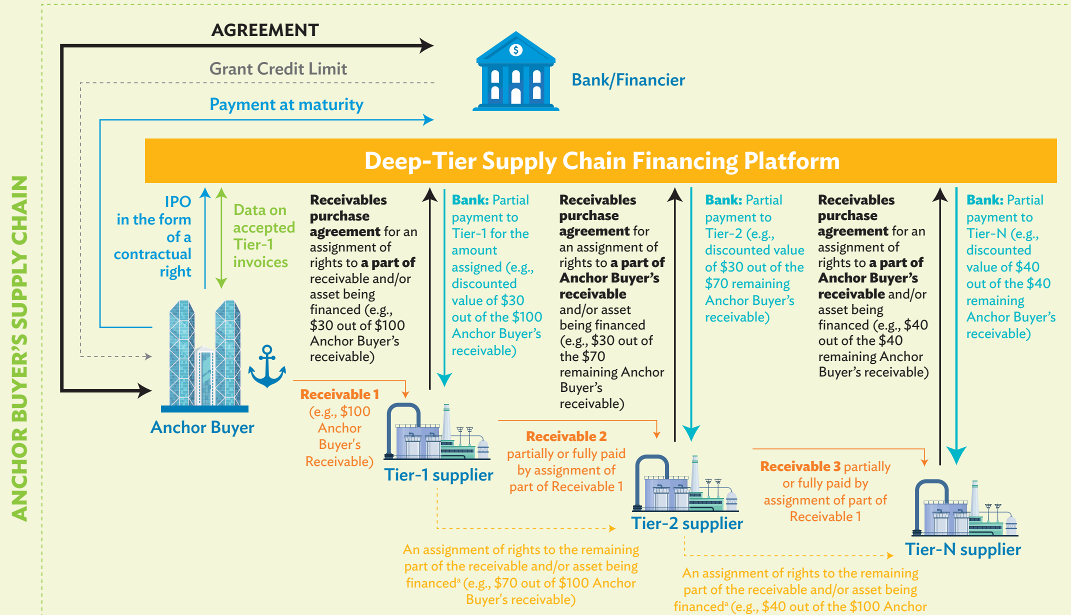
Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

Figure A2.1: Legal Model 1—Retention of Part of Purchase Consideration



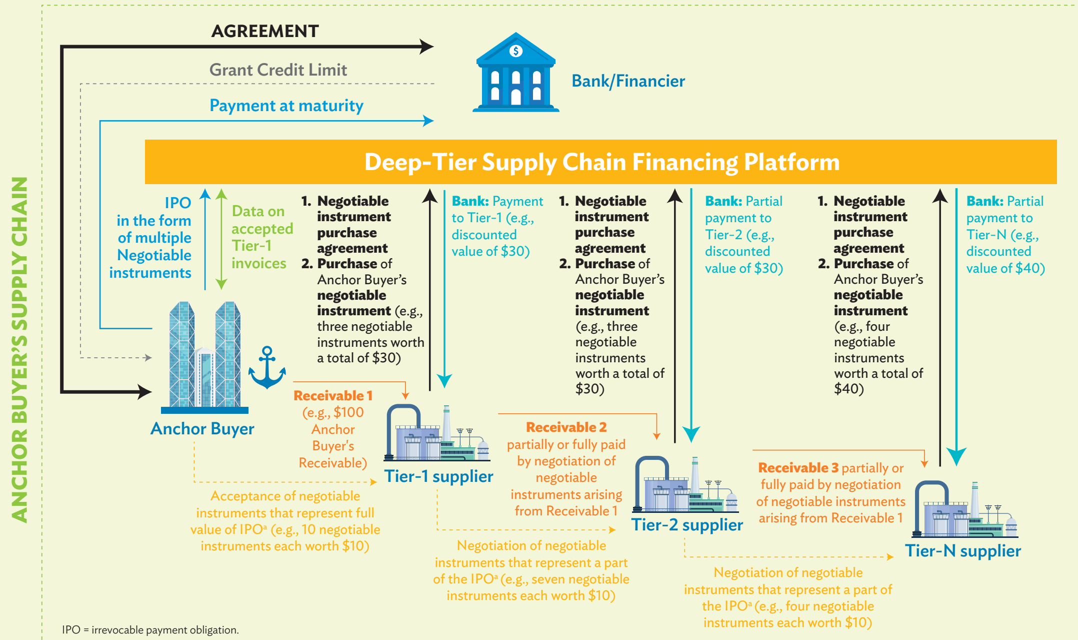
IPO = irrevocable payment obligation.
[a] Payment terms include payment under Anchor Buyer's Program.
Note: All parties enter into platform terms and conditions.
Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

Figure A2.2: Legal Model 2—Assignment of Part of the Rights to the Receivable



IPO = irrevocable payment obligation.
[a] Payment terms would include assignment of rights to Receivabke 1 to be provided for in the Contract of Sale and Purchase between the suppliers.
Note: All parties enter into platform terms and conditions.
Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

Figure A2.3: Legal Model 3—Negotiation of Negotiable Instrument



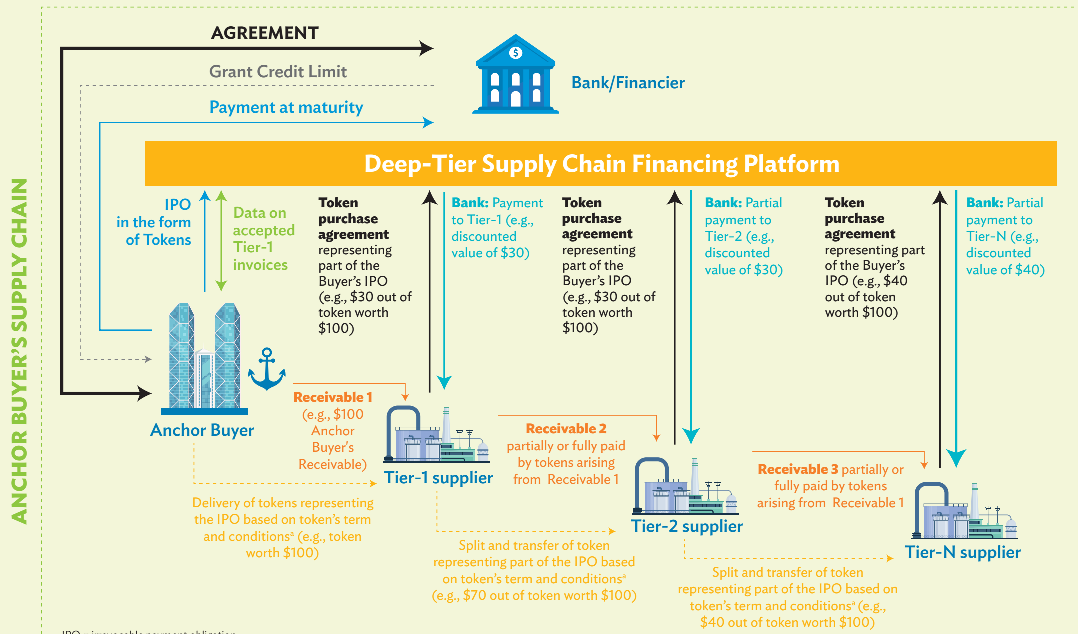
IPO = irrevocable payment obligation.

[a] Payment terms would include negotiation of negotiable instruments that represent Receivable 1 to be provided for in the Contract of Sale and purchase between the suppliers.

Note: All parties enter into platform terms and conditions.

Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

Figure A2.4: Legal Model 4—Tokens



IPO = irrevocable payment obligation.

[a] Payment terms would include payment via tokens that represent Receivable 1 to be provided for in the Contract of Sale and Purchase between the suppliers.

Note: All parties enter into platform terms and conditions.

Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

APPENDIX 3

SUMMARY OF CHALLENGES FOR DTSCF IMPLEMENTATION

Table A3: Summary of Challenges for Implementation

Area	Challenge	Mitigant	Call to Action
Lack of harmonized legal approach	Diverse approaches exist for domestic DTSCF, but no solution has successfully addressed cross-border DTSCF yet.	This note provides guidance on DTSCF legal framework.	Promote standardized legal structures and the exchange of best practices.
Regulatory landscape	Heterogeneity of regulatory frameworks across jurisdictions, including the lack of enabling regulatory framework supporting the recognition and enforceability of electronic negotiable instruments (and tokens).	Contractual rights address enforceability, although further consideration is needed around choice of law and dispute resolution. Increased attention on MLETR, which effectively addresses the legislative gap related to some negotiable instruments in electronic form.	• Perform legal analysis and advocate harmonized legal framework. • Governments may find value in exploring the MLETR as a benchmark for policy reform.
Currency considerations	Interplay of various currencies; natural component of cross-border trade.	Involvement of financial institutions with experience in managing FX risk.	Foster collaboration within the banking industry to develop a common solution that mitigates FX risk for SMEs.
Access to technology	SMEs may lack capability, resources, or interest to engageand invest in technology.	Collaborative approach involving preceding suppliers, i.e., customized solution and education.	Educate stakeholders and explore an incentive mechanism to foster proactive engagement of the entire supply chain.
Ownership	Shared responsibility for the identification, education, and onboarding of suppliers is crucial but not always clear.	Commitment of reputable anchor buyer.	
Successful transfer of benefits down the chain	Lack of willingness from preceding supplier to share benefit with the following supplier.	Flexibility to discount receivables on a need basis.	

continued on next page

Table *continued*

Area	Challenge	Mitigant	Call to Action
Information barriers	Resistance, especially from tier-1 supplier, to share commercial terms.	Technology solutions capable of supporting exchange of information with encrypted data point.	Encourage innovative technology solutions.
Buyer linkage	Underlying goods or services must be related to the anchor buyer supply chain.	Technology solutions capable of monitoring and/or tracking end-to-end goods flows.	
Excessive reliance on anchor buyer	An excessive reliance can make supply chains vulnerable to disruptions, including to anchor buyer bankruptcy and strategic decisions.	Engagement with reputable and responsible anchor buyers.	Stringent due diligence and risk monitoring by the financier.

DTSCF = deep-tier supply chain finance, FX = foreign exchange, MLETR = Model Law on Electronic Transferable Records, SMEs = small and medium-sized enterprises.

Source: Asian Development Bank, the Bankers Association for Finance and Trade, and Simmons & Simmons JWS Pte. Ltd.

Deep-Tier Supply Chain Finance

Unlocking the Potential

This publication explains how deep-tier supply chain finance (DTSCF) can unlock financing for small and medium-sized enterprises (SMEs), improve financial stability, and ensure complex supply chains become more transparent and resilient. This co-publication by the Asian Development Bank and BAFT (Bankers Association for Finance and Trade) provides guidelines on industry definitions and legal frameworks that can underpin success in scaling DTSCF. It shows how DTSCF has the potential to reshape traditional relationships, create new business opportunities for financiers, and help bridge the trade financing gap.

About BAFT (Bankers Association for Finance and Trade)

BAFT, the leading global financial services association for international transaction banking, helps bridge solutions across financial institutions, service providers and the regulatory community that promote sound financial practices enabling innovation, efficiency, and commercial growth. BAFT engages on a wide range of topics affecting transaction banking, including trade finance, payments, and compliance.

About the Asian Development Bank

ADB is committed to achieving a prosperous, inclusive, resilient, and sustainable Asia and the Pacific, while sustaining its efforts to eradicate extreme poverty. Established in 1966, it is owned by 68 members —49 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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