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Supply Chain Finance: Where Will the Future Lead?

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Supply chain finance (SCF) as a concept has enormous potential, but its adoption is significantly slowed down by the way it is implemented. This article examines how better integration can release the benefits.

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In recent years, supply chain finance (SCF) has become an increasingly popular offering. In its typical form, it is driven mainly by bank, as opposed to corporate, logic. The idea from the bank's standpoint is to take a 'reliable' corporate customer for whom they have unused credit lines and offer them a loan equivalent, that is, lend to them against a fully unconditional obligation to pay. Because of accounting arbitrage, which means that the agreement is essentially with the seller and the buyer is merely providing confirmation, this can be accounted for differently. It also generates additional fee income, similar to traditional trade finance using counterparty bank lines.

Two major implications in the way it is designed separate the system for confirmation, which is essentially a step backwards from traditional trade finance where banks tracked logistics, and the more buyer-centric marketing channel. Neither of these are obvious.

First is the idea of a separate bank- or platform-sponsored confirmation system. Supply chain management and collaboration is a major trend of the 21st century, with significant developments facilitating such co-operation. Electronic invoicing (e-invoicing) and procure-to-pay (P2P) modules have become a standard part of wider systems for buyer/supplier co-operation. That in itself goes to a much wider area of information sharing and process co-ordination.

However, it appears that many banks and software providers are ignoring these trends, and are instead trying to set up single use links to cover only SCF. At the same time, many of the supply chain collaboration providers, with all the information needed to provide seamless financing, often do not specially develop such capabilities and link to finance providers. Operating a separate system just for SCF purposes creates an additional burden on the company, either in terms of IT integration or sometimes queasy manual re-entry from a separate system, without delivering an operational benefit. In addition, the overall benefit depends on highly unpredictable supplier on-boarding.

Implementation of supply chain integration, serving multiple functions to improve overall collaboration but also providing appropriate modules to support SCF programmes, has little marginal cost to corporates, as the whole process is fully justified regardless of use of SCF. It is then up to the banks to certify appropriate providers in order to offer the product to whole 'ecosystems' based on such collaborative systems.

This shift from dedicated systems just to facilitate SCF to supply chain collaboration systems with a link to financing is likely to change the whole dynamic of the industry. It should also accelerate a move to industries/verticals where such collaboration is well developed. This would include many distribution networks as well as supplier networks. It also gives potential finance partners access to a variety of performance information that would allow the building up over time of various higher risk/margin products, on top of purely credit risk-based 'traditional' SCF products, based on a degree of performance risk.

The second important aspect in the SCF programme design is the prevalence of a buyer-centric approach. The argument for this approach is that large credit-worthy buyers provide the largest arbitrage in the cost of funding, have sufficient size to justify high set-up costs such as IT integration, and also have sufficient power over their supply chain to 'force' the adoption, usually by pushing credit terms and then offering a solution. However, recent European directives significantly limit such ability. On top of this, the parts of the banks where SCF product is hosted do not normally have access to credit exposure analysis for mid-sized companies, but can access lines within their relationship bank for large buyers.

The downside to this approach is that it is funding suppliers against a perceived non-existent risk. If you are a mid-sized company, would you worry about your AA rated major customer going under? Therefore liquidity would be the only selling point. This approach creates accounting complications for buyers in some structures, particularly in tri-party agreements where there may be a risk of reclassification of liability. It also creates large concentrations for finance providers and is normally only adopted by a small minority of suppliers, with supplier on-boarding being quoted as the biggest barrier to adoption.

The major complexity is that the people who need to sign the agreement are suppliers, not the buyers with whom the financial institution are in discussion. They pay the costs and deal with a variety of legal and accounting issues, such as compliance with accounting requirements under IAS 39, FAS 140/FAS 166 and, most importantly, various restrictions and covenants in lending agreements. It may be difficult for the buyer's procurement team to effectively perform the role of a sales force for the finance provider, particularly selling a highly complicated product that, from the supplier's point of view, requires multiple decisionmaking including that of treasury, finance directors, sales, legal, and tax. This often results in large and supposedly attractive deals with close to zero utilisation.

A Seller-centric Approach to SCF

The alternative approach is seller-centric, such as in distributor finance, where the seller is driving the buyer's adaptation. So buyers provide confirmation through a seller/mutually supported system in exchange for longer payment terms - but at a price. It makes marketing of the solution much easier as all documentation, pricing, etc needs to be concluded with a single party, the supplier, and the only input required from the buyer is information on invoice approvals, which is normally centralised in a single department.

It may still require some IT involvement, but this is not that different from the buyer-centric model. It also allows the supplier, who pays for the programme, to easily recover the cost by adjusting the price by more than the cost of financing. This makes it attractive even for strong suppliers without a particular need for financing. In simple terms, this service is becoming just another product sold by the supplier's sales force and priced to an appropriate margin; for example a stock keeping unit (SKU) for payment terms to be included in the orders can be created.

This still requires appropriate sales force training and support but makes the financing potential revenue and margin enhancing driver, which is not dissimilar to leasing or other customer financing solutions that already form a good revenue stream for many suppliers.

The key question for financial institutions supporting financing going 'upstream', otherwise known as distributor or customer financing, would be risk management as they have to deal with a large number of smaller credits. Giving the diversification and short-term nature of such risk, there is a strong argument that the risk can be more predictable than large individual exposures and can be addressed in three ways:

1. Accessing individual SMB buyers
This would limit most banks to their local markets and may also have pricing implications, as these risks are priced as part of the process with different return expectations than larger businesses. Most importantly, it would require close cooperation and profit and loss (P&L) sharing between different parts of the bank dealing with large corporate and smaller business, which would be attractive but difficult to implement in a 'normal' bank decisionmaking structure.

2. 'Outsourcing' the major part of the risk to credit insurers
Outsourcing allows access to global credit appetite, as credit insurers, unlike banks, take credit risks for small and medium-sized enterprises (SMEs) across the globe as their main business. In addition, it will foster pricing arbitrage, as a credit insurer's pricing is broadly based on short-term trade credit losses that are typically lower than banking default models based on longer term loans, and therefore can achieve lower pricing.

The core reservation about insurance, which is that it will not pay for disputed invoices, is overcome by buyer confirmation. This also addresses the possible misidentification of the buyer, which is another frequent reason for claim disputes. With all parties, including bank and insurer, being on the same system a lot of automatic controls can be put in place.

3. Portfolio financing
With asset-backed commercial paper (ABCP) conduits recovering, designated confirmed trade receivable conduits may be a valid option, although this may take time to develop.

Conclusion

SCF as a concept has an enormous potential; however its adoption is significantly slowed down by the way it is implemented. Bringing SCF into overall context of supply chain integration and building it as part of overall co-operation process and systems, as opposed to an isolated project, should make it easier and more beneficial for corporate customer and calls for different type of alliances than the 'traditional' model.

Moving from the downstream process, typically from the large buyer to typically smaller suppliers, to upstream, from typically large seller to smaller distributors/customers/supply chain partners, is likely to be easier to adopt. However, it also requires a co-operative approach, particularly on the risk side where credit insurance and capital markets solutions may facilitate this process. It also means much wider co-operation within corporations. This is no longer just a financing product and needs to become an integral part of overall supply chain co-operation.

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