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As "traditional" supply chain finance (i.e. financing of confirmed receivables for major corporate buyers to benefit their first tier suppliers) is reaching its maturity, the market focus is shifting towards what the next step will be. The developing areas are: financing BEFORE the invoice is confirmed (moving to PO financing etc.); and going multi-tier. Of course, these are very important areas, and it is likely that we will see further growth in them, however there is one obstacle to this growth – it is very difficult for a financial institution to evaluate or hedge performance risk (unlike credit risk that is easier in this respect). It also requires a buyer centric root to market – this is a logical step for the relationship bank but it is typically poorly supported by institutional structures when dealing with suppliers.

The other approach to maximising potential growth will be to take the core principal of SCF (separation of credit and performance risk) and see which markets could benefit from these techniques. While these approaches focus only on the period between invoice approval and the actual payment, they are substantially widening the market. The following factors arise when considering this approach:

TECHNOLOGY

The traditional SCF model was based on single purpose platforms, either bank owned or independent; that captured buyer data on approved invoices and provided them to the financier. Seller on-boarding stood as a secondary (but obviously vitally important) process. With new software technologies (making the process more light touch), expanded use of e-invoicing, supplier networks and incorporation of access to all stages of invoice confirmations in standard procurement driven systems/portals (both general and industry specific); this type of information is no longer a privilege of large corporate buyers with sophisticated financing platforms. Easy and reliable ways of obtaining buyer confirmation is becoming widely available for even small and medium size buyers, which is increasing the circulation of approved invoices that may be funded.

PRODUCT IMPLICATIONS

The mixed risk (credit, performance, fraud) nature of receivables asset class makes managing and structuring solutions for financing/risk mitigation difficult and expensive. From the perspective of the clients, financiers and regulators, the current solutions are unsatisfactory. Moving to buyer confirmed payables tremendously changes the nature of financing by placing a number of financial solutions into direct competition with products that carried less risk (such as loan based distributor finance structures, credit card based receivables/payable solutions, etc.).

CREDIT INSURANCE

While traditional credit insurance programs have massive advantages as risk mitigation tools (depth of credit appetite, global nature and very high cost efficiency versus other tools), their use is hindered by a lack of clarity surrounding claim cover. This is reflected in many examples, such as internal and regulatory models used by banks, and rating agency criteria for securitization. As a result, instead of true risk substitution to A- AA rated cover, credit insurance is often only considered as a partial enhancement depending on the lender's assessment methodology. Therefore, instead of relying on credit insurance to cover the risk (giving access to wider geography and risk appetite); many lenders have to conduct their own credit approvals on individual buyers, making the whole process less efficient and more costly.

As a response to this, some insurers have developed various specialised policies for financial institutions, effectively causing the insurer to take unusual risks for extra premium. Credit insurers themselves are facing the same problem as other financiers- they have expertise assessing and managing credit risk but far less managing performance, fraud etc., which has led to the exclusion of these risks in their policies. If these risks could be eliminated altogether, credit insurers simply would not face this problem. With buyer confirmed receivables, major causes of potential claim non-payment can be eliminated (i.e. contractual disputes, seller's fraud, wrong buyer identity, etc.), while the others (such as timeliness of declarations or premium payments) can be easily controlled through basic IT means. This elimination of risk allows for the insurer to enhance its portfolio to A-AA level, as far as default probability is concerned. The only remaining issue is that the credit

insurer does not provide immediate payment, which requires having a liquidity buffer/interest reserve to cover such delay (that can vary depending on the insolvency or prolonged default cause of loss). However, given that the maximum claim payment period for a "clean" claim is well defined in the policy, and with typical small claims percentage and low interest rates, the impact is negligible. For example, 1 per cent claims ratio on outstanding balance, with 90-day average payment and 5 per cent p.a. funding cost would only increase the annual funding rate by 0.01 90/365 5%=1.2 bp to compensate for lost interest.

SECURITIZATIONS

While being a long established way to finance receivables, securitizations have suffered several setbacks. Traditional securitizations are structured to avoid any "real" risk transfer from the originator, with reserves to cover defaults, dilutions and concentrations, and liquidity and program wide support on top of it. While these structures are cost efficient, corporate sellers have identified some issues with their use, as rating agencies tend to designate these structures to the company balance sheet, even if the transaction is fully FAS140/IAS39 compliant. Banks, on the other hand, have their regulatory pressure that caused large numbers of multi-seller conduits to go back to their books. These increased pressures led to a growing market of specialised credit insurance solutions (specifically designed around these issues, but normally priced at a significant premium), and a significant market for "equity" tranches. Moving to exclusively financing confirmed receivables fundamentally changes the risk profile by eliminating performance and fraud risk, which allows for the utilisation of "normal" whole turnover credit insurance as a significant enhancement.

LENDER'S COMPETITION

Historically, factoring and invoice discounting industries were difficult to enter, due to two highly complex risks. The first of these is fraud prevention; fraudulent activity including "fresh air" invoices, selling the same invoice twice, etc. Fraud risk correlates to the seller's financial position, as most high profile frauds are committed by desperate sellers, so reps and warranties are of little help. The majority of these risks can be eliminated by buyer confirmations.

The second issue is managing performance risk, which can also be linked with the supplier's credit risk. For example, a massive product issue may simultaneously cause the seller's insolvency, and invalidate a large portion of receivables.

In the past, those who could efficiently manage these risks (e.g. banks and major players) have enjoyed sustainable excess margins, whereas inexperienced competitors disappeared after a few losses. While buyer confirmation is still not a 100 per cent guarantee of enforceability (for example there is still a risk that there is an undisclosed seller charge over invoices, which could lead to a dispute about the use of proceeds), it is far easier to verify compliance than to deal with the whole spectrum of risks in the sphere of unconfirmed receivables. Limiting the funding to a period between invoice approval from the buyer and eventual payment allows multiple other lenders (bank and non-bank) to enter the market, which will competition within the industry. Due to expanded databases and experience gained by the credit insurance market, new entrants can directly compete with specialised financiers who have experience in a particular industry (even if it is 80/20 rule – being far more efficient dealing with 80 per cent of cases at 20 per cent of the cost).

ALTERNATIVE FINANCE

Buyer-approved invoice financing is already a major focus for alternative finance. Like securitization, alternative finance attempts to remove the banks by connecting passing risks and rewards of receivable to the buyer. The fundamental difference between alternative finance and securitization lies in the way that risk is distributed. Whereas, in securitization, there is virtually no 'real' risk transfer, alternative finance platforms tend to pass risk directly over to the buyer. Separating the buyer's credit risk (that is achieved by using buyer approved invoices) from the seller's performance and fraud risk (assuming the platform has implemented appropriate legal structures, systems and processes) makes the asset easier for the investor to understand. Some platforms also combine the product with credit insurance, which makes the final product significantly less risky. While confirmed receivable products are better suited for alternative finance, the remaining question is the quality of credit scoring models. Typically the model delivers reasonably stable statistical performance on a highly diversified portfolio (so meets the needs of banks, large trade suppliers, securitization conduits, credit insurers or others using such large pools), however this is far less reliable with individual SME exposure, so individual investors picking a few of such risks may face a very different degree of risk.

DISTRIBUTION FINANCE

Another interesting area is distribution finance, a product mainly offered to major OEMs to finance their distributors. While often structured as a loan, using collateral over some inventory, many of these programs (such as in the technology industry) do not have an inventory recovery value; they rely on the credit of the distributors themselves. This creates a complete overkill with the structure appropriately designed to deal with marketable inventory

(and having expense and administrative burden to support programs for credit week partners trading relatively liquid goods) used in the area where its advantage is minimal and cost/administration is high. A well-designed program, combining supply chain finance type structures between the OEM/Distributor and its channel partners- in addition to the appropriate use of credit insurance- can construct an equivalent of a distributor finance program. This should be more cost efficient, with little administration needed, which can be especially important at a time in which the industry is undergoing structural change, for example, the sale of Commercial Distribution Finance by GE- a dominant player among several industries.

CONCLUSION

Closer supply chain collaboration, flexible systems, and the ability for buyers to provide real time confirmation of invoice acceptance; creates a new asset class of buyer confirmed receivables. Unlike 'normal' receivables, this limits the credit risk of the buyer. The effects of this reach far beyond the sphere of large buyers (which has so far been the focus of supply chain finance markets), and provides efficient financing to a much larger receivables market. It significantly expands the pool of potential lenders (including banks, non- bank financial institutions and various alternative finance providers); provides a new life to "traditional" credit insurance by resolving key limitations of policies; and provides different opportunities for the use of securitization tools. While increasing the depth of supply chain financing (PO finance, pre-shipment finance, inventory finance, etc.) is an important development, it is not the only root to grow the asset class. Simple and cost efficient financing of buyer confirmed receivables, for all types of buyers- not just large and creditworthy companies- has the potential to significantly expand receivables financing, without creating unsustainable bubbles. By making this part of financing highly efficient from a cost and administration standpoint, there are additional opportunities for high cost specialised players to finance pre-approval. These players may have better knowledge of performance, logistics and other risks, but may not have access to cheap funds to build value added financing before invoice approval without the need to effectively subsidise the part others can do more cost effectively (and either part of the chain can also work as an origination partner to the other products).