

Supply Chain Finance — Evolving Beyond the Basics

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- Trade finance providers are evolving solutions related to supply chain finance.
- Supply chain finance models have evolved to the point of being operationalised.
- Risk mitigation has become increasingly important in the context of a global financial crisis.
- The evolution of supply chain finance will require closer links between finance and procurement (operations), including the development of complementary metrics.

Trade finance is the oil that lubricates the engine of international commerce. This reality has been convincingly illustrated since late 2008, through the global financial crisis, which remains top of everyone's mind today. Trade finance is an industry that is long-established with proven products, processes and business solutions, which have been remarkable in their resiliency across markets and through every variation of economic condition over hundreds of years. It is equally true, however, that trade finance has its issues and challenges – several of which were engendered by the industry itself.

One challenge is the high rates of discrepancy in trade-related documentation, sometimes estimated to involve more than three-quarters of the documents presented for payment under documentary letters of credit (LCs). Such rates of discrepancy, now reduced to some degree by the increasing use of document templates and technology, tend to invalidate the risk-mitigation elements of documentary LCs, which are core products in trade finance. This long-standing issue significantly dilutes the value

proposition of trade finance and has contributed to a broad distaste for the use of documentary credits.

A second illustration relates to the commoditisation of the products and solutions provided by trade financiers. The industry has allowed its valuable (arguably indispensable) service to become a commodity, resulting in pricing that undervalues trade finance, both at the transaction/instrument and at the structuring and advisory level. Despite the highly specialised expertise required to deliver solutions and the effectiveness of trade finance – from risk mitigation to financing, to payment facilitation and the provision of detailed, near real-time information – the service offering has become a commodity, with a pricing profile to match, because the industry has failed to communicate effectively the value that trade finance provides.

These factors, in combination with others such as changing global sourcing patterns and the increasing leverage of large buyers relative to smaller suppliers, have created an imperative among trade financiers: the need to innovate in the face of market conditions that would have seen traditional providers (mostly financial services companies) cut out of the trade finance equation. Traditional providers must evolve, or fade into irrelevance, as importers and exporters seek more cost-effective and efficient solutions to their trade finance needs.

Enter Supply Chain Finance

Following some hesitant early steps, and some bolder, more innovative initiatives by certain providers of trade finance, the industry appears to have settled on supply chain finance as the next step in the evolution of the trade finance value proposition.

As importers and exporters across much of the globe shifted from traditional trade finance terms and instruments to settlement on open account, the idea of the movement of money as a parallel to the physical movement of goods and services evolved slowly over a period of 10 years, to the point where it is now a serious area of focus among a number of top-tier trade finance providers.

From the early days, when non-bank providers sought to carve out a niche in a bank-dominated business, to the current situation in which it is now a “mainstream” concept, supply chain finance has evolved significantly, if slowly.

Initially, the industry struggled to define this solution in a consistent manner and wrestled with the challenges of operationalising, pricing and marketing the product. Today, supply chain finance has developed into a sustainable business proposition: progress is visible, even as the industry continues to debate the merits – and nature – of supply chain finance.

Technology has advanced such that major providers have developed, implemented and gone “live” with open account and supply chain finance modules and functionality, and several leading global providers have invested significantly in the development and deployment of internally developed supply chain finance platforms.

Even in this early stage, top-tier providers are able to demonstrate success in attracting anchor corporates to sign on to supply chain programmes, though the “on boarding” of suppliers remains a challenge in the most advanced markets.

The global financial crisis has motivated some movement back to traditional products, due to the familiarity of these products and the relative robustness of their processes and practices, as well as the “tried and tested” nature of their risk-mitigation features. Confirmations of documentary LCs have been especially important in the facilitation of trade in various regions of the globe.

Despite this reality, and even in the depths of the financial crisis, trade financiers have continued to move ahead in the development of supply chain finance products. The crisis will have the ultimate effect of ensuring that some focus is placed upon adding a level of risk mitigation to supply chain finance solutions.

In the background of these developments, there is quiet debate about whether open account and supply chain-based solutions are actually innovations, or simply a thinly veiled repackaging of familiar bank-lending products. At the extreme, some argue that the whole notion of requiring new solutions and product offerings misses the mark completely: trade financiers ought rather to focus on improving the processes and efficiencies (as well as the price structure) around existing and largely proven products and solutions.

This debate has its merits: the processes and mechanics of traditional instruments would benefit significantly from improvement, and technology is now such that improvements can be practically implemented, allowing traders to take fuller advantage of what is, in the end, an evolved business model that operates across every region, legal tradition and commercial context in the world.

Equally true, however, the trading patterns and transactional expectations of importers and exporters are evolving, technology is enabling unprecedented transparency and speed at the transactional level, and the solutions offered by trade financiers must evolve to meet those new realities. Supply chain finance, even if it is in part a repackaging of familiar products, is interesting and timely in that it attempts to take a holistic view of international trade and recognises the link between the physical movement of goods and the flow of related funds.

The fact that emerging supply chain finance solutions are complements – perhaps serious challengers – to traditional products suggests that they are more than simple repackaging; they are an attempt by the industry to respond to and remain relevant in a changing global trade landscape.

Supply Chain Finance: A Nascent Value Proposition

In markets leading the way in supply chain finance, such as Asia and North America, people have successfully transitioned from roles in logistics to high-profile positions in financial institutions, with specific mandates to develop solutions around supply chain finance. Even as the debate about the ultimate positioning

of supply chain finance continues, a major organisation in China has been looking at the question of supplier-driven versus buyer-driven trade financing models.

While thought leaders certainly speak of supply chain finance on both sides of the transaction (importer and exporter), few providers have the financial resources or the global footprint to implement end-to-end solutions. The focus for many is on supplier finance programmes, at least as a first step, as providers extol the virtues of supply chain finance for both buyer and seller.

From the early days, when definitions of supply chain finance varied significantly from one provider to another, the business is evolving to the point that a common language is being adopted, and those further along on the development curve are beginning to speak of “best practices” even within limited portfolios of clients.

As a number of providers (from banks to investment firms to hedge funds) have exited the trade finance business over the course of the economic crisis, others have extracted significantly higher margins from traditional products (three and four times those at the pre-crisis level), and have continued to invest in, and to better articulate, their value propositions around supply chain finance.

The challenges around “on boarding” of suppliers on to supply chain finance platforms have been recognised. Providers are working to convincingly offset suppliers’ objections, which centre on the notion that suppliers would have to provide too much visibility relative to their financial position, thereby losing negotiating leverage and perhaps even opening the opportunity for buyers to squeeze margins tighter or to hold suppliers “hostage” from a financing perspective. Some banks seeking to extend their activities into a client’s supply chain have encountered mistrust and resistance, while others have been successful in driving into global supply chains.

Trust and partnership are important in the business of trade and may prove to be even more important in the context of evolving models of supply chain finance.

Trade bankers, particularly those tasked with a supply chain finance mandate, have been gathering metrics, both financial and physical, relating to global supply chains, and are demonstrating their ability to generate significant value for clients through supply chain solutions.

Specific illustrations of savings from supply chain finance programmes can be seen on the “procure to pay” side as well as the “order to cash” side of the transaction. Leading trade and supply chain finance providers are integrating cross-border cash management and working capital solutions into a holistic product targeted at international transactions. From enhanced working capital management to improved visibility in global cash positions, to advanced (and timely) reporting, the value proposition represented by supply chain finance is showing signs of viability and flashes of clarity – both of which were missing from the model just a year ago.

The Model Meets the Bottom Line

Industry metrics suggest that mid-market and corporate clients have an opportunity to free up liquidity representing 2–4% of annual revenues through enhanced financial management processes and technologies. Whether this means reducing days payment outstanding or cost of goods sold on the seller’s side, or improving days sales outstanding or enhancing receivables and cash flow management, on the buyer side, the opportunities are there.

Just as leading banks have integrated various business lines into transaction banking units, with the objective of providing integrated solutions and reducing costs, the drive now is for a more integrated approach to financial and supply chain management within top-tier client organisations.

For several years, leading providers have spoken about the importance of top-level dialogue (client to bank) on the challenges and opportunities in the supply chain space. Some have achieved such dialogue and are focusing on the implementation of solutions that require corporates to look holistically at their finance, treasury and procurement functions.

While some banks argued two or three years ago that integrated trade finance and cash management businesses were illogical (given the disjointed and discrete nature of the operations of their client base),

top-tier providers now argue that corporates that fail to take an integrated view – which requires their treasurers to work much more closely with their operations/procurement groups – are losing out.

Enhanced, holistic procurement, finance and treasury management leads to significant benefits which translate into shareholder value and can be traced directly to core performance metrics such as earnings per share.

Next-Generation Supply Chain Finance

As banks and corporates work to align offerings with organisational structure and drivers, the next level of development of the supply chain finance value proposition will flow directly from efforts to link finance and operations, or financial and procurement functions, more closely. Supply chain and logistics specialists now engaged in financial institutions will find a stronger voice of support among traditionalist bankers and will help define the next-generation trade and supply chain finance solutions.

The global economic crisis, which has motivated a refocus on due diligence and risk management, has driven trade bankers back to fundamentals: the business is again about the movement of goods and commodities; the underlying asset is again central to the equation, and balance sheet machinations have lost primacy over those fundamentals.

The focus on underlying assets and the movement of goods will drive operational functions such as procurement much closer to financial functions such as trade, cash and treasury over the coming year or two.

Thought leaders in this field have begun to consider the question of complementary operational and financial metrics, and the high-level dialogue now needs to shift from vision and strategy to operational reality – and must be duly reflected and managed through optimised financial disciplines and practices.