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Banks Must Take the Broadest View of the Supply Chain

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Supply chain finance (SCF) is coming under scrutiny due to businesses' need for alternative sources of liquidity, yet its potential remains both misunderstood and underestimated. This article discusses the development of SCF and how it may be used to address corporates' evolving working capital concerns.

Working capital and, more specifically, the optimisation of working capital is vital to corporate success and sustainability. This much is well understood. Also apparent is the fact return on investment (ROI) and return of capital employed (ROCE) - two universally-applied corporate benchmarks for profitability and capital efficiency - rely on optimal working capital management for enhancement. In today's business environment, this means a strong focus on supply chain finance (SCF).

Yet it's in our understanding of SCF that opinions start to diverge. There are numerous definitions in existence and, while none of them is technically incorrect, there is only one that can safeguard the best possible results with respect to working capital optimisation. Here it is: SCF is anything that injects liquidity into, and removes risks from, the supply chain.

This is a broad classification; although one that marks a clear departure from the historical view of SCF. Its simplicity is also deceptive. SCF was previously, and almost exclusively, buyer-driven: based on revolving receivables purchase programmes designed to extend days payable outstanding (DPO). This reflected the corporate focus on inventory/supplies optimisation and the safeguarding of liquidity, so therefore served its purpose.

Modern supply chains have, however, changed. The extent to which corporate working capital requirements now vary has forced SCF to be more holistic, as well as more geared towards both buyers and suppliers. The result is tangible cost and efficiency gains when employed on either a regular or one-off basis.

For the banks offering SCF, such a comprehensive view is a tough ask - but it's a requirement that must be met if they are to remain relevant to trade.

Rising to the Challenge

Banks naturally wish to rise to this challenge, yet they must begin with an analysis of the ways in which corporate approaches to optimising working capital have changed. Several trends that started some 15 to 20 years ago were finally accelerated by the 2008 global financial crisis. For instance, the tried-and-tested risk-mitigation technique of diversification has stopped being a vertical process (of vertically integrating the supply chain) and is now a horizontal one (of partnering within supplier networks). This has resulted in the establishment of manifold multilateral relationships that are giving rise to convoluted supply networks rather than linear chains.

There are two reasons to believe that this is an excellent strategy for corporates. First, it means there is a contingency in place in the event of a key supplier failure, so operations need not necessarily grind to a halt over one weak link. Second, it can foster greater supply chain collaboration, with collaborative sourcing encouraging product development and the optimisation of productivity/cost ratios, rather than the historical preference for supplier squeezing.

Such collaborative optimisation is crucial. In a fast-moving world consumer expectations change continually and rapidly, while fierce competition can turn the new into the old almost overnight. Given this scenario, it is becoming increasingly common for successful companies to leverage supplier innovations to their own benefit. Yet such synergy doesn't always go hand-in-hand with the lowest-sourcing price, meaning traditional cost-cutting measures - once the default method of increasing margins - are giving way to innovatory measures. This is, in turn, fundamentally changing the way many companies are aligning internally and, by extension, what they need from SCF solutions.

Banks are, of course, only now catching up with such developments, meaning that the majority of SCF offerings have to be better aligned to corporate realities.

A case in point is the increasingly strategic evolution of the procurement function. Once responsible solely for securing stable supply at a favourable price and ensuring compliance, procurement can now not only save money, but help to make the most of company spend. This is an ongoing shift; although one that's changing the game: with value generation throughout the entire supply chain/network being the logical conclusion. Certainly, working capital optimisation is an issue that now transcends corporate treasury - banks' historical focus-area - and even risk departments.

The result is that corporates need solutions that boost the efforts of the numerous in-house links in the working capital chain and also extend similar benefits to suppliers: a complex requirement that many banks may underestimate.

The Need for Speed in Innovation

Providing solutions to mitigate risk and manage cash is what transaction banks do, and they have always sought to do so in line with market developments. As a result most banks have the main building blocks of SCF in place, but they should be quick to offer innovation.

An example is the letter of credit (LC), which is the cornerstone of all banks' trade finance offerings. Certainly, its risk-mitigating properties have stood the test of time. Yet as demands for greater operational efficiency increased in line with the growing popularity of open account trade settlement, the more innovative banks found ways to automate LCs - thereby combining risk-mitigation and processing efficiency. Going a step further, the most innovative banks have managed to integrate innovations on the trade side with cash management capabilities -creating holistic solutions that can be tailored to address market and corporate-specific requirements.

Yet banks cannot consider this the end of the story. In order to act as a strategic partner and a leader in SCF, banks need to recognise that the discipline goes beyond the fundamentals of risk management, technology, flexibility and cash management.

Acting as a strategic partner for a corporate is a two-way, collaborative, process. While some companies will need guidance as to how they can restructure and use SCF techniques to optimise working capital, others will be ahead of the curve in this respect and will look to their banks for help in driving further efficiencies. In this sense, the evolution of SCF can be a collaborative effort, meaning banks must be willing to be reactive as well as proactive.

Yet there is no 'one size fits all' approach, which banks need to recognise. Some degree of standardisation is possible obviously, but it is virtually impossible for SCF to be a standardised offering. Variations in corporate working capital requirements aside, the supplier onboarding process - which can span geographies, multiple compliance processes and varying levels of operational sophistication - cannot be reduced to a tick-box exercise.

Supplier onboarding is crucial - a process in which banks can play a dual role. Obviously, banks are tasked with the practicalities of the process but they may be equally responsible for securing buy-in. After all, SCF is at a relatively early stage in its development and, given historical business practices that have not always worked in suppliers' favour, some might question the extent to which it truly can be beneficial for all supply chain participants. As a neutral third party, banks can be crucial in spreading the word and getting the message across - a role that they should take equally as seriously as developing solutions.

The Evolution of Supply Chain Finance

The full potential of SCF cannot be realised until both corporates and banks fully understand and appreciate the myriad ways in which it can be used to address the range of physical and financial threats to supply chain sustainability. That said, even once SCF is firmly on the map, harnessing its potential will still throw up barriers that require navigating. The main stumbling block to its future development will be the challenges associated with managing risk and legal/compliance processes across borders, particularly as the regulatory landscape continues to change. Then there are the pressures banks face to adapt to customers' constantly changing service needs and expectations - as well as meet increasingly stringent compliance requirements: all showing that innovation in SCF is a far from easy process within the current banking environment.

Yet ultimately SCF is a mechanism for trade facilitation and trade is the 'real' economy. With that in mind, what needs to be done will eventually be done. We are already seeing major, high-level developments that can help drive supply chain finance, such as the Bank Payment Obligation (BPO) and this can only continue.

The BPO is a set of rules, jointly produced by financial messaging provider SWIFT and the International Chamber of Commerce (ICC) Banking Commission, that may be defined as an irrevocable conditional undertaking to pay given from one bank to another. More practically, it may be viewed as an electronic LC, and alternative means of trade settlement.

While the BPO's impact on and benefits for corporates has yet to be fully realised, it can enable a smoother process for discounting and allow for payment risk mitigation even on open account. Given this, it has the potential to become the weapon in the SCF armoury. Although, like other supply chain innovations, it can be the key to keeping things straight and simple. Back to top

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