

# SCF as a core element of supply chain risk management

Supply chain risk plays an increasingly important role in today's supply chain management, writes **Dr Sebastian Hölker**, Head of Global Innovative Trade Products at UniCredit.

Recent progress in technology and supply chain management has created supply networks that are at the same time highly efficient and entirely vulnerable. Trendy apparel, automotive lighting parts, computer chips and smartphone bezels – they all have in common that they lose most of their value if not available at exactly the right time and in the correct sequence.

Disruptions in these modern supply networks cause severe losses – not only for the downstream buyers that are left without precious supplies, but eventually for the entire supply chain after trade is disrupted, contracts cancelled or damages claimed.

Supply chain risk management uses technology and analytical methods to cope with threats affecting all aspects of the supply chain. Examples include over-dependency on third-party providers to deliver critical services, lack of compliance with external rules or internal specifications, market volatility, product tampering, theft, natural disasters, perceived lack of social responsibility/sustainability and many more.

Techniques that companies apply to manage these risks include supplier profiling, performance measuring, RFID (Radio Frequency Identification) or GPS (Global Positioning System)-based tracking of deliveries, compliance monitoring, co-ordinated external communication and the like. What is interesting in this respect is the fact that software solutions exist that combine these risk management techniques and create real-time visibility and transparency of combined risk-related data.

Given this level of effort and ingenuity invested in supply chain risk management, it is surprising that one core element of risk tends to be largely neglected: The risk of counterparty failure due to insolvency. But the old adage of the chain being only as strong as its

weakest link fits perfectly to describe these cases. For the supply chain, it makes no difference if the disaster that strikes the supplier has a natural or a financial cause: Eyjafjallajökull and Lehmann Brothers both eventually meant the same thing to the supply chain.

Far-sighted enterprises have realized that the financial health of their supplier base belongs to the core supply chain risks that have to be managed the best way possible.



**“FAR-SIGHTED ENTERPRISES REALIZE THAT THE FINANCIAL HEALTH OF THEIR SUPPLIER BASE BELONGS TO THE CORE SUPPLY CHAIN RISKS.”**

► **Dr Sebastian Hölker**, UniCredit

But how so? How can the financial health of a supplier be monitored and influenced in the same way as physical supply chain events? What does supply chain finance have in common with RFID?

If you have a look at the techniques applied in supply chain risk management and supply chain finance, it becomes obvious that very similar mechanisms and techniques apply to both.

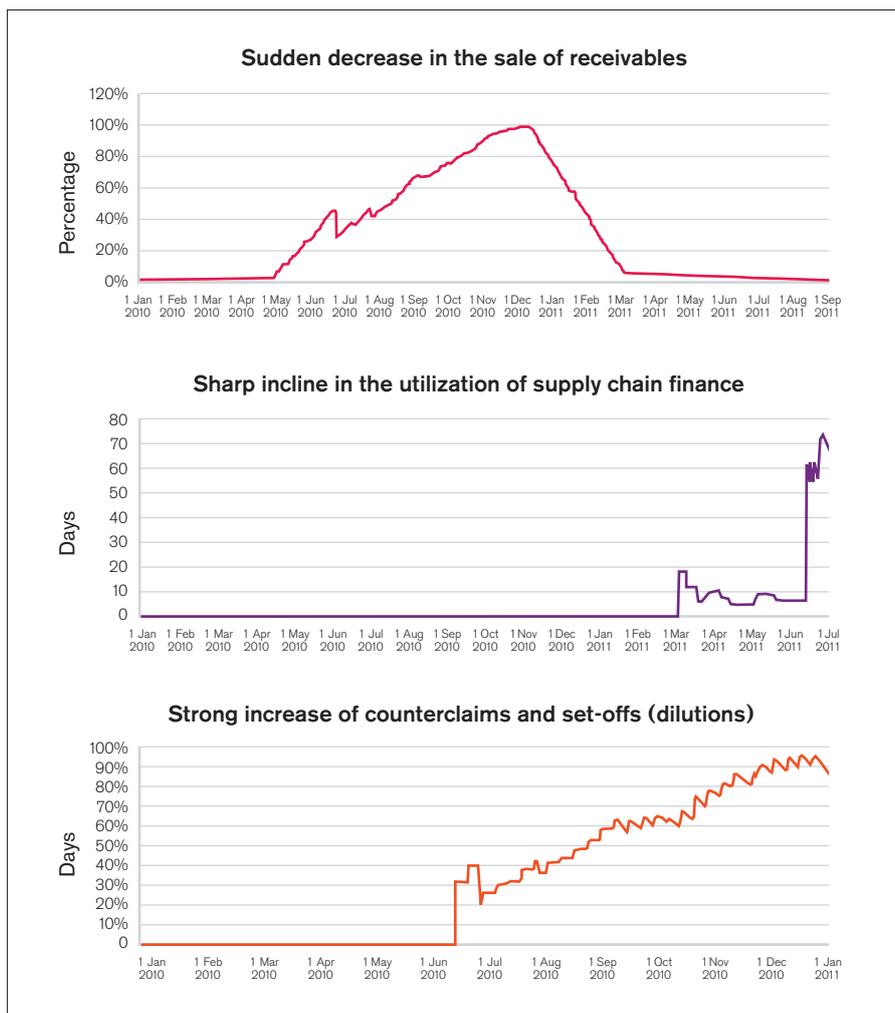
Supply chain risk management begins with data – and so does financial risk

management in modern supply chain finance. If in the past the availability and accuracy of data was regarded as a major challenge to overcome, today we have an abundance of data available in real-time from end-to-end of the supply chain. So how can the financial “supply chain” benefit from this data availability?

It can do so if the corporate players and their financial institutions carefully assess whether the traditional plain vanilla working capital loan really is the best answer to the financing needs of complex supply chains. The traditional working capital credit line that solely relies on the supplier's creditworthiness is still one of the most utilised sources of funding for suppliers all over the world. As easy and straightforward as it seems at first glance, it is a vulnerable source of short-term liquidity. Banks tend to readily offer credit if the borrower's balance sheet is healthy and if some other “soft facts” are presented to the bank in a convincing manner. But as soon as the borrower does not fit in the standard patterns, fails to fulfill certain hurdle rates or covenants, the liquidity once so readily available becomes unaffordable or unreachable – even if the supplier has a strong and healthy trade relationship with a top-rated buyer.

From the bank's perspective, this traditional approach also has its drawbacks. A borrower might look excellent from a balance sheet perspective and thus be entitled to borrow at attractive rates – whilst at the same time the company's true economic health already has deteriorated massively due to internal or external influences the bank has no information about.

Modern supply chain finance (SCF) programmes have answers to these issues – to the benefit of the supplier, the buyer and the bank alike. SCF in this context (and in line with the BAFT-IFSA definitions on open account trade) refers to all solutions that encompass a combination of technology and services



information, both the bank and the buyer can investigate whether there is a harmless reason for this drop or whether a problem persists in this individual supplier relationship. We received customer feedback that these kinds of alerts foster a communication between the procurement and the finance departments that has not been there before.

- 2. Sharp incline in the utilisation of SCF facilities:** Here, the alert triggers real-time investigation: has the supplier's financial health deteriorated? Did banks withdraw working capital facilities so that the supplier is now dependent solely on SCF facilities? Or is there a positive explanation, for example, that the supplier made some investments to increase production capacities and needs more SCF funding because his other lines are blocked by these investments?
- 3. Increase of counterclaims and set-offs (dilutions):** An increase in dilutions usually shows that the supplier has problems – either with regards to quality/production capacities – or that he is close to insolvency so that other customers withhold payments, limiting the supplier's delivery capabilities. A buyer who is warned of these problems in time can decrease his dependency on this individual supplier or find co-operative measures to help the supplier overcoming these problems.

These examples are very basic in the way that they use data that is traditionally part of the SCF activities.

They show, however, how banks can and should make use of the real-time analyses of the data that is readily available in modern supply chains. Not only for the direct benefit of the buyer and the supplier, but also for making an asset class that traditionally is regarded as a low-risk asset class even less risky: the investment in trade receivables.

As of today, credit processes, regulators and banking supervisors still do not fully recognise these additional risk mitigants. It is quite obvious, though, that once they start doing so, SCF will become an even more important element of modern supply chain risk management.

that link buyers, sellers, and finance providers to facilitate financing during the life cycle of an open account trade transaction.

As per the BAFT-IFSA definition, SCF concepts have in common that they move away from an isolated one-one-one view of the client-bank relationship and take into account at least two, often more, players of the supply chains and networks. They traditionally do so by following two very basic principles:

- Assign the credit risk to the party that is best suited to take it.
- Take into account at least two players at the same time.

A third principle becomes more and more important and is key to the risk monitoring functionality of SCF:

- Move away from a balance sheet risk analysis reflecting the borrower's past economic health to a transaction-based, real-time risk assessment.

The first two principles are fulfilled by the fact that a typical SCF programme allows the typically weaker supplier to

generate liquidity by selling its receivables against a better-rated, stronger buyer. The main risk (and thus the main factors influencing the price and availability of liquidity) are moved from the weaker to the stronger party, so that the bank can provide large facilities at favourable rates. This way, two main constraints the supplier usually faces are taken care of: affordability and availability of funding. This serves not only the supplier's interests but also stabilises the supply chain as a whole by avoiding unforeseen supplier insolvencies.

The third principle serves both the buyers and the banks as it provides real-time visibility and a never-before-seen transparency of the supply chain activities that have an impact on its financial stability. Three simple examples illustrate this, using the data that is generated by modern SCF systems without any additional work or hassle for any of the involved parties:

- 1. Sudden decrease in the sale of receivables:** The SCF system gives an alert if the utilisation of SCF facilities suddenly drops. With this