The 2007 guide to
Financial supply-chain management

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Global Trade Review Readers Poll 2006

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Best Trade Finance Bank, Hong Kong
The Asset Triple A Transaction Banking Awards 2007

Best Trade Bank in Hong Kong
Best Trade Bank in China
Best Trade Bank in Asia
Best Factoring House 2006
Trade Finance Awards for Excellence – 2006
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The financial supply chain is an important concept for CFOs and treasurers to understand. However, it is one that they might be unfamiliar with, and certainly it is unlikely to be at the top of their agenda. Corporates have fixed resources and although they obviously pay attention to elements of financial supply-chain management, such as working capital or risk management, the holistic idea of financial supply chain management has yet to be fully embraced.

Instead, CFOs are more concerned with problems associated with the physical supply chain and, in many cases, have made significant improvements to its operation by investing in supply-chain management teams that work with different parts of the organization, and third-party supply partners. The financial supply-chain requires a similar collaborative effort to bring finance, treasury and accounts payable into cross-functional teams, which work with a company’s external partners.

This will not necessarily be easy. Many of the structural changes that have taken place in the global market have accentuated the confrontational aspects of business: cutting costs has been about buyers and sellers fighting over every last cent. However, although that combative culture of cost-cutting is not in any danger of dying out, strategic sourcing and supplier relationship management techniques mean that the emphasis has moved from pushing costs down the chain towards taking costs out of the overall supply chain.

This change of approach on the
part of buyers is not based on philanthropy but on the hard commercial logic that if a buyer can help a supplier to reduce its costs, the buyer is more likely to be able to negotiate unit price savings. Many retailers, for example, now regard their supply chains as mini ecosystems that need to be managed collectively in order to compete better with rival supply-chain ecosystems.

**New role for banks**

Banks need to be aware of the changing dynamics of international trade and understand how they can best fit into this supply-chain ecosystem. Most importantly, they need to be seen to be driving costs out of the financial supply chain. At first glance, it might appear that banks are being asked to cannibalize their own revenue streams: after all, they have earned good money on the back of inefficiencies of trading processes between buyers and sellers in a paper-based environment.

However, the opportunity to improve processing efficiencies should create a situation where banks, buyers and suppliers benefit. In an electronic environment and armed with much better information to manage risk, banks will be in a position to lower transaction costs and to reduce the cost of finance. For efficient banks, financial supply chain management and the efficiencies it brings will be welcomed because of the cost savings it will create and the potential to win a much larger share of a buyer’s supplier base if they get it right.

The banks’ role is now about accelerating efficiencies in the financial supply chain. Inevitably, that means that some services provided by banks will become commoditized and have lower margins. Consequently, the banks that will prosper will most likely be those large, efficient transaction banks that have economies of scale.

The challenge for banks is to leverage their technology infrastructure and customer reach more effectively. Perhaps most important, banks need to better understand their clients’ changing procedures. They need to know how the relationship between buyer and seller – and importer and exporter – works along with end-to-end
processes such as purchase-to-pay. Banks also need to understand how those relationships will continue to change in an increasingly global and electronic environment and how banks must ensure that they are better connected to supply-chain eco-systems.

**Increasing competition**

Just as banks are waking up to the strategic importance of understanding their clients operations, so too are a number of technology players, which are moving into the financial supply-chain arena.

Logistics organizations are leveraging the information that their processes generate to move into financial services, while technology providers such as SAP and Oracle, as well as niche providers such as TradeCard and PrimeRevenue, are also recognising these opportunities.

At the same time, business process outsourcing to third parties is increasing. Corporates are evaluating the benefits of moving accounts payable and receivable functions to offshore managed service partners or outsourcing it to companies such as Xansa, Accenture, Capgemini or Logica.

Although banks have always been involved in these processes on a small scale – for example, performing document checking and payment approval – the explosion of business process outsourcing creates challenges for banks’ role in this important element of the financial supply chain.

Moreover, the developments in networked technology and management information systems have encouraged corporates to re-evaluate the way they manage risk, interact with their supply-chain partners over the net and seek to manage working capital across the chain. This poses real opportunities and threats for financial institutions.

The financial supply-chain arena is a complex environment and it is not clear what shape the market will eventually take. Corporate expectations are growing and banks need to work hard to keep up. This booklet seeks to provide an insight into the evolving world of financial supply-chain management and explain where the banks can best serve buyers, suppliers and carriers along the supply chain.
Before considering the concept of the financial supply chain, it is important to understand the broader concept of supply-chain management and the key developments that are shaping the way that both physical and financial supply chains are managed. Supply-chain management (SCM) is now well established within large organizations as an initiative that offers competitive advantage by driving down the cost of goods and improving customer service. Traditionally, SCM has focused on the processes that support the fulfilment of physical goods, either from sourcing to settlement or purchase-to-pay for the buying organization, and from order to cash for the supplier. Critical SCM processes include demand planning, sourcing, logistics, inventory, warehousing and risk management.

The supply chain is often coordinated rather than “owned” by the supply-chain director – who is usually not a board member – and a prerequisite for success is effective collaboration across historically insular functions such as sales, marketing, procurement, logistics and systems. Typically, finance and treasury have not been heavily involved in these initiatives.

**Key trends impacting SCM**

Globalization and the intensity of competition for both large and small organizations has created an environment where there is relentless pressure to reduce the cost of sales and improve customer service. SCM, low-cost-country sourcing, offshoring and outsourcing have been used to deliver against these business objectives.

Low-cost-country sourcing to Asia-Pacific, eastern Europe and Latin America continues unabated – indeed, it is common for global supply chains to span several continents – as corporates seek to develop existing supplier relationships or switch countries to ensure continued downward pressure on unit costs.

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Necessarily, different functions involved in SCM have different
priorities. Buyers tend to concentrate on unit price reduction, logistics on fulfilment, cost control and delivery certainty and supply-chain teams on end-to-end processes and reducing total cost of fulfilment. For best-practice organizations, shaving 1% or 2% off the total cost of fulfilment is critical to maintaining a competitive edge. And, as opportunities within the physical supply chain are realized, the focus is shifting to financial supply-chain-related opportunities.

For decades, international trade has been heavily dependent on paper-based processes and traditional risk management instruments such as letters of credit and collections. In the past decade, the drive towards paperless processes and electronic data and documents has gathered momentum. That is not to say that paper, or indeed letters of credit, are disappearing. Far from it, it is simply that the growth in open account based transactions, particularly in Europe and North America is more pronounced. However, many organizations are increasingly leveraging technology to improve purchase order, invoice and cash management processes and are moving to open account.

Rates of dematerialization vary considerably across sectors and companies but migration onto networked electronic platforms will have a profound influence on the way companies will manage international trade and their supply chains.

Transparency or visibility across physical and financial supply chains enabled by networked technology can give the supply-chain director, CFO and treasurer the information they need to better manage key processes, risk and financial flows.

Changing management practices means that there is a growing acceptance that teams and partners need to collaborate more and share information better. Buyer mentalities are shifting away from pushing costs down the chain to working for sustainable improvement by taking costs out of the entire chain.

The traditional adversarial relationship buyers have had with suppliers is changing. Modern strategic sourcing and supplier relationship management techniques work best with a “win-win” mentality, acknowledging that sustainable improvement is best achieved when there is a business benefit for both parties.

The need for transparency and visibility is not just being driven by commercially driven projects inside the business. Compliance and more intrusive regulatory requirements are forcing buyer and seller organizations to better track physical and financial flows. Anti-money-laundering, anti-terrorism, Sarbanes-Oxley, climate
change and green initiatives also benefit from reducing paper and being able to track and control flows of goods, information and cash more effectively in a digital environment. In effect, compliance is helping drive the business case for dematerialization.

**Financial supply-chain management**

CFOs, treasurers, bankers, third-party logistics providers (3PL) and technology providers have very different definitions of financial supply chain management (FSCM).

For some, the concept is very simple. It is the management of the cash flowing between parties within the supply chain, whether in the form of a payment or short-term finance. For others, the focus is on the average cost of capital or finance for the total supply chain and working out how to reduce finance costs across the entire chain.

One approach to FSCM is to calculate all finance-related costs embedded within the end-to-end supply chain and determine how best to reduce them without redistributing risk to the weaker members. This analysis looks at cost of finance, transactions fees associated with trade service instruments such as letters of credit and credit insurance and also costs incurred in the processing of purchase orders, invoices and payments. These costs are usually hidden and spend analysis is often difficult.

Another view of the financial supply chain sees it as a collection of processes that track the exchange of cash, inventory, title and management information across the supply chain. These processes may be supported by paper-based systems or electronic platforms and are typically disconnected. In this context, FSCM is a set of cross-functional disciplines that manage key processes around risk, working capital and management information. The emphasis is on end-to-end process flows.

What is important is that there is an informed view of the impact a change in working capital management processes in one organization can have on the other parties along the chain and on end-to-end costs. Extending payment terms is a good case in point. The initial balance sheet and profit-and-loss benefits for the buyer are easy to calculate. The supplier, on the other hand, probably suffers on two levels. Delayed payment puts pressure on liquidity that is alleviated by short-term borrowing, usually at rates higher than those
the buyer could attain. As the suppliers’ cost of capital is usually higher than that of the buyer – sometimes by as much as 3% to 4% – the overall financing costs of the whole chain will increase. These additional costs tend to find their way back to the buyer at a later date. The enlightened buying organization recognizes this and aims not to push more costs down the chain but to take costs out of the chain, by helping key suppliers get better terms and improve processes.

For banks, FSCM as a concept was initially a marketing umbrella to repackage such traditional products as trade, insurance, payments and cash management. More recently, banks have reviewed traditional trade and cash management services and identified those elements of the value proposition that could be developed to better serve their customers’ physical and financial supply chain. In this context, banks tend to define FSCM services in terms of five interrelated groups: payments and cash management; working capital management and supply chain finance; risk management; process improvement (either through dematerialization or managed services); and business intelligence.

**How does FSCM improve business efficiency?**

Understanding what the financial supply chain means is the first step on an important and complicated journey. Getting endorsement from business colleagues in related supply-chain functions is critical and this can only be effective if the conceptual ideas on performance improvement are converted into a strong business case and tangible benefit.

FSCM covers a large area: the CFO, treasury and supply-chain director are likely to have a different view on which elements are most important to their part of the business. All three managers need to be encouraged to work together to determine shared pain-points across the business and joint performance improvement opportunities.

Good questions to ask the joint team include:

- Is the priority to reduce cost of goods sold and reduce supplier costs?
- Is the focus on improving working capital?
- Is there a drive to move the business to paperless processes?
- Is the priority to provide managers across both physical and financial supply chain with better management information?

In practice, the answer to all these questions is probably yes. The real challenge is how these initiatives are joined up and managed as part of an integrated programme. Evolving best practice suggests the first step is to form a cross-functional project team.
that could also include procurement, compliance and logistics.

A recommended next step is to map out end-to-end processes to better understand the manual and electronic systems that support them, interdependencies, information and documents exchanged and to pinpoint those ubiquitous ‘black holes’ that exist between departments.

Another important task is to get a better appreciation of targets within each function and the performance measures each is working to. It is not unusual that key managers have targets that conflict within the financial supply chain. A good example of this is where finance is asked to improve working capital by extending days payable outstanding (DPO), whereas buyers are looking to further reduce unit prices by capturing early payment discounts.

The debate about the definition of FSCM will continue. What is more important for a company is agreeing the scope and ambition of the FSCM programme and the responsibilities and interdependencies within the programme. Setting up cross-functional teams is the easy part, getting them to agree performance improvement targets and to work well together is much more challenging.

This project also needs to be joined up with related projects involving information systems and the physical supply chain. Involving external supply-chain partners is likely to bring new ideas and a fresh perspective and will also help your team better understand their business drivers.

**Key elements of the financial supply-chain management**

- **Purchase To Pay (P2P) process**
- **Order To Cash (OTC) process**
- **Physical Supply Chain**
- **Financial Supply Chain**
- **Documents & Data (paper & electronic)**
- **Process Improvement**
- **BPO Shared Services**
- **Working Capital Management**
- **Payments & Cash Mgmt**
- **Risk Mitigation**
- **Visibility Control / MIS**
- **Electronic Docs Dematerialization**
- **Inventory A/P A/R Cash Flow**
- **Supply Chain Finance - All parties within the supply chain**

Financial Supply Chain Management (F-SCM)
According to recent research, logistics and transport-related costs typically account for somewhere between 4% and 7% of unit prices – and increasing sourcing from distant low-cost countries is pushing this share higher. Supply-chain management teams and their logistics partners have expended considerable effort to control upward pressure on costs. Part of the solution has been to better manage information flows and dematerialize paper-based processes.

Research also reveals that finance-related costs – the cost of finance, bank and insurance fees and transaction-related costs – embedded within end-to-end financial supply processes, account for a similar proportion of unit prices. Surprisingly, there are few examples of organizations taking an SCM approach in order to better manage end-to-end financial supply chains. However, this neglect of the financial supply chain is coming to an end in many organizations. It is well recognized that buffer stocks have been an intrinsic feature of supply chains – largely as a crude mitigant of risk – and that they result from the paucity of management information across functions and supply-chain partners. In addition to stock buffers, supply chains usually have cash buffers as a result of uncertainty over payment dates. Improved visibility along physical supply chains as a result of improved electronic information is acting as a catalyst to create a similar transparency along financial supply chains.

Other changes that are helping to create a receptive climate for FSCM include developments in networked technology, a greater understanding of end-to-end processes and a new spirit of collaboration inside and outside organizations. As obstacles that were previously considered too difficult or costly to remove are overcome, the potential business opportunities of FSCM have become clearer.

FSCM considers cash, working capital and risk as a set of processes and related projects that need to be managed cohesively and as an integrated programme that dovetails with an information systems strategy. The
challenge for many organizations is to get the treasury and finance departments to move from a “head office and control” mind-set, and encourage them to get a better understanding of end-to-end processes by building closer working relationships with procurement, supply chain, logistics and the key suppliers. The objective is to eliminate these buffer stocks and process inefficiencies for all parties in the supply chain.

Banks too have been encouraged down a similar path. Understanding purchase-to-pay and order-to-cash processes is a small but important first step. The real challenge for finance, treasury and banks is to convince businesses that improvements in financial supply-chain processes will result in a lower cost of goods sold, higher productivity and better management information.

Who is managing the financial supply chain?

Cashflow, working capital and risk management are typically the responsibilities of finance and treasury. Within finance, accounts payables looks after payments to suppliers and accounts receivable chases customers for payment. Demarcation and functional responsibilities are usually well defined.

As soon as a company starts to take an SCM approach to its business and seeks to improve processes that involve suppliers and supply-chain partners, the clean lines of control and responsibility start to become blurred.

Where does the responsibility for improved and paperless processes get allocated – the supply chain, IT or the functions to which it relates? In practice, there is a very fragmented approach to the e-enablement process.
as payables pushes for electronic purchase order management, receivables pushes for electronic invoices and logistics works with third-party logistics providers (3PL) for electronic documents.

Large buying organizations have introduced matrix management techniques to ensure that supply chain managers have more than just a coordinating role. Supply-chain directors are working hard to build effective cross-functional teams. CFOs and treasury do not to tend to manage their part of the business in terms of a series of financial supply chains. It is fair to conclude that financial supply chains remain largely unmanaged. Key elements of the chain are obviously very tightly controlled but what is being advocated under FSCM is that these projects be extended and aligned to wider information system and physical supply-chain programmes.

However, the situation is changing: some North American companies have even appointed financial supply-chain managers. The CFO in many companies is becoming more aware of the benefits of a financial supply-chain approach and is encouraging accounts and treasury to take a more active role by sitting on cross-functional teams. Working capital management initiatives work best when they include finance, treasury, logistics, procurement, operations and IT. Similarly, reverse factoring projects – the concept of banks lending to suppliers at a cost usually associated with the buyer – are most successful when companies have adopted a cross-functional team approach.

The question of who manages the financial supply chain now is less relevant than that of who should be managing it going forward. In order to gain traction such a programme needs buy-in at the highest level – the CFO should take a leadership role. However, it is important to recognize that this is not always possible and both the supply chain team and the treasurer can be appropriate substitutes.
In an ideal world, all critical supply-chain management processes would be supported by electronic systems. However, the reality is patchier. Parts of the chain, such as transport documents and payments, are increasingly digital. But most elements of the chain, such as purchase order processing and invoicing, remain paper-based.

A growing number of corporates are working to remove paper from these processes and are incentivizing suppliers to follow suit. Many buying organizations and their suppliers are focusing on key elements of the financial supply chain and dematerializing purchase order and invoice-related processes.

Networked technology and event management

So why has interest in dematerialization increased? Improvements in networked technology, supply-chain management applications and lower implementation and integration costs are encouraging many buyers and suppliers to revisit the business case for dematerialization.

Of particular appeal are some of the information management systems being developed that make key events along both the physical and financial supply more transparent to the parties involved. Alerts or trigger-based type status information can be captured into management dashboards that give supply-chain managers, buyers and logistics managers up-to-date information on production and shipment status.

Much of the initial work to e-enable elements of the supply-chain process has been driven by logistics organizations and IT companies specializing in electronic data exchange and data management.

Providers of enterprise resource planning (ERP) and global trade management (GTM) solutions are also building solutions. Corporates are looking to use these networked applications and connect to their supplier and supply-chain partner communities through supplier portals and extranets.

At the moment, few organizations can boast end-to-end straight-through electronic processing and some large corporates remain unconvinced that the costs...
associated with e-enablement are necessarily justified by the business benefits predicted, such as cost savings and improved management information systems. Purchase order management and invoice production, presentation and approval processes are increasingly migrating to electronic platforms while many organizations have instead elected to e-enable key elements of the purchase-to-payment process.

Typically, large corporates begin the shift to electronic processing by moving their key processes onto digital platforms, usually through their ERP systems, and then connecting these systems to their supplier base. Large buying organizations can either mandate suppliers to integrate to buyers’ systems or encourage them to do so by highlighting the business benefits.

What role should supply-chain partners play?

For many companies, the key question is not if they will move to an electronic environment but when they will. Supply-chain partners, including logistics, ERP, banking or increasingly business process outsourcers (BPO) should ask themselves what role they can play in this migration and in the continuing management of these platforms.

The question of how to help companies move to an electronic environment is crucial for banks. Transaction banks’ core competencies are in secure data management, which is at the heart of payment and cash

Supply chain finance
management services. Banks are aware that traditional payment services are becoming commoditized and that margins will be squeezed with the introduction of the Single European Payment Area (SEPA). Banks also appreciate that there are limits to what they can do in an electronic letter of credit environment and that they need to consider what value-added services they might be able to provide in a structured open account environment.

The provision of a broader set of transaction management services is appealing, not simply as a source of fee-based income but as a mechanism to capture the supply-chain event and trigger information that enables them to provide better risk management and supply-chain financing services to a range of parties along the supply chain.

The role of banks in dematerialization

A key issue for banks is whether they should provide a full e-enablement suite and platform to connect buyers with their supply-chain partners, or whether they should simply feed off the electronic data from buyer, supplier and carrier systems to provide the financing services described above.

Another alternative for banks could be the provision of discrete transaction management services. There are a number of critical elements of the overall value proposition, including electronic document preparation, disc mapping, data authentication, online collaboration, compliance checking, integration to supplier systems and online reconciliation, such as purchase order to invoice matching and supplier onboarding (the cost of adding a new supplier relationship).

What do buyers and suppliers want banks to provide for them? Recent research suggests that corporate expectations are for banks to provide some of the services but not the central platform, which is being competed for by a number of solution providers including banks, IT firms, and outsourcing and logistics companies. Furthermore, some buyers and suppliers prefer to build this capability themselves using a mixture of ERP and specialist services providers.

A number of banks have joined forces under the umbrella of the Trade Services Utility, which is coordinated by SWIFT, to build a platform that will provide banks with a transaction management engine based on agreed standards. This will be managed in a secure environment with electronic
documents such as purchase orders and invoices passing between supply-chain partners.

**Transaction management services**

Most banks are building a suite of transaction management services to support supply-chain management processes and to provide a platform covering sophisticated FSCM services – initially around supply-chain finance but increasingly around working capital and risk management.

The demand for electronic transaction management services across the purchase-to-pay supply chain has yet to be fully tested by the banks. Early feedback from their customers suggests that corporates do not want different bank proprietary platforms, which are expensive for buyers and their suppliers to connect to. Rather the preference is for a multi-bank platform or a platform that is cheap to connect to and relatively easy to switch out of.

What is certain is that banks must be able to interact with the evolving electronic environment and be able to provide a range of supply-chain financing, risk management and business intelligence services that their buying and selling customers require. In the shorter term, banks must be able to provide a mix of services that recognize the different levels of e-maturity of their customers and the confusing world of mixed formats, including paper, emails, faxes, imaged documents, EDI and XML files.

Transaction management is important not just in itself but because of the impact it has on visibility within the financial supply chain and the business intelligence it creates. If data is being managed more efficiently, then information about risk, compliance and supply-chain partner performance becomes available. Most important, information about end-to-end supply-chain finance becomes more accessible and easier to use for all parties.

Banks need to realize that the business intelligence generated by electronic information management is important not only to the treasurer of a company but also to the CFO and the supply chain, logistics and procurement departments. It is vital for banks to look outside their existing relationships and realize the value of the information being created. It might turn out that how information is presented becomes far more important than how it is collected, or, indeed, who collects it. Whatever the case, it is clear that the electronic transactions business will be central to the financial supply chain.
Supply-chain finance

Supply-chain finance (SCF) is a critical element of FSCM. It describes a range of financing instruments used to provide working capital at any stage within the end-to-end supply-chain management process and can be provided by banks, buyers, suppliers or a range of financial institutions, including factoring companies.

SCF can take many forms, including structured finance, finance for raw material suppliers, pre-shipment, in-transit, inventory, distributor, warehousing and post-shipment finance. Each type is usually provided by discrete or specialist business units within banks – integrated and seamless supply-chain propositions are rare.

Borrowers are concerned with three aspects of SCF – its availability, cost and flexibility. From a supplier perspective, a key consideration is availability of working capital finance. In the letter-of-credit environment, the supplier had a ready instrument on which to secure pre- and post-shipment finance. In the increasingly open account environment, they must manage risk and raise finance in different ways. In Europe, for example, credit insurance plays an important role.

The second important factor is the cost of finance. In keeping with the drive to remove costs from the supply chain rather than pushing them onto the weakest members, the goal is to reduce the overall cost of finance for the end-to-end supply chain. This is good news for buyers, suppliers and carriers but it probably means that one of their banking partners will have to give up some of its lending margin.

A range of factors determines the cost of finance – not least of which is the amount of information a lender has about the borrower and the nature of the trading transaction to which the finance relates.

Logically, if lenders can better track the trade cycle by having access to status information along the fulfilment process, then the risk management process should be more efficient and consequently the cost of the risk premium contained in the lending margin can be reduced.

Logistics organizations already provide status information on the progress of the goods or containers. If banks can get critical information regarding contract, purchase, order status, delivery status and invoice status, they will be better placed to provide transaction-backed finance.
linked to the changing risk profile of the trade.

The migration of purchase-to-payment (P2P) processes to an electronic environment is vital for a trigger or event-based approach to SCF. Important triggers for pre-shipment finance are contracts signed and purchase orders accepted. Triggers for post shipment finance include invoice presented, invoice approved and payment file issued. Much of the focus for the banks and the buying organizations presently revolves around the opportunities to improve the financing offered to suppliers at the point of invoice approval.

Reverse factoring and payables finance
A number of forward-looking buying organizations have recognized an opportunity to help their suppliers secure cheaper finance, sometimes at rates closer to the ones the buyer can achieve, using reverse factoring or payables finance. This process centres on an irrevocable payment instruction from the buyer, early sight of the approved invoice for the supplier, usually over a web portal, and an early payment opportunity secured by a mouse click as and when they require it. The supplier is effectively getting working capital either from the buyer, in the form of a negotiated early payment discount, which will always be higher than the buyer’s cost of capital, or from a bank that has agreed to effect early payment with a discount that reflects the agreed cost of capital. Buyers argue that this cost of capital
should be nearer their cost of borrowing as they have minimized the risk for the bank with the irrevocable payment instruction at an agreed future date.

Buyers are also keen to ensure that where their suppliers have taken early payment the liability on their balance remains as a trade creditor and is not recast as bank debt. Despite much debate on the subject, no finite conclusions have yet been reached about how this liability should be treated on buyers’ balance sheets.

**A buyer perspective**

Buyers are keen to be able to reduce the cost of finance for suppliers as it strengthens their relationship and gives them leverage to negotiate down unit prices. Buyers can provide finance themselves by virtue of an early payment but the supplier pays for this in the form of an early payment discount.

Buyers are under increasing pressure from finance departments to improve working capital by extending payment terms. This might mean early payment discounts are lost. Extended payment terms are not popular with suppliers, who want the reverse. A longer days sales outstanding period has a negative impact on liquidity and increases cost. Being able to offer the supplier access to cheaper finance might help soften the blow.

Buyers are keen to be able to offer early payment facilities to their suppliers if it helps reduce the cost of sale. A number of specialist providers have developed systems to help buyers provide an internet-based platform to offer this facility to their suppliers. The large enterprise resource planning providers are also equipping their platforms to offer this feature. Many of the specialist system and service providers are working with banks to provide an integrated service, while some banks are also keen to build their own solutions.

Many of the reverse factoring initiatives under way in large buying organizations are exploratory in nature. In the long term, the optimal supply-chain platform needs to be flexible enough to cope with major changes in supply-chain liquidity. At the moment, best-of-breed technology platforms allow for financing to be provided by the banks and the buyer using a dynamic discounting tool. This can include allowing a highly liquid buyer to use its own funds to finance the supplier.

If power shifts to the supplier and, the buyer still seeks to extend payment terms, the supplier might choose to fund this working capital requirement by demanding a larger payment to incorporate its cost of financing this arrangement or by alerting their bank to the lending opportunity. At the moment,
the focus is on invoice and payment triggers. In time, though, platforms need to be able to deal with a whole range of triggers, typically produced at pre-shipment stage, such as an accepted purchase order.

Creating the SCF platform is only part of the challenge for buyers. To extract full value, invoice processing and approval processes must be efficient. It is not unusual for a reverse factoring initiative to be run in parallel with an Electronic Invoice Presentment and Payment-type project.

**The supplier perspective**

Financial supply-chain inefficiencies manifest themselves in a number of ways. Suppliers typically produce paper invoices, present them to the buyers and then wait for payment. The accounts receivable department often complains of buyer “black holes” and the uncertainty that surrounds payment dates. Consequently, suppliers would like to gain greater visibility into the approval process as a result of electronic preparation and presentation: having early sight of these processes would provide better cashflow certainty.

If extended payment terms are forced upon suppliers, then access to cheaper finance might be attractive. Availability of additional finance and the current cost of finance will help determine whether suppliers use the new reverse factoring platforms being offered by buyers. Other factors influencing supplier take-up
include ease of use and whether there are any costs associated with using this platform, such as systems integration or a process change.

The reverse factoring model works best when the cost of finance for the supplier is appreciably higher than the buyer’s. This is not always the case. In the fast-moving consumer goods (FMCG) and automotive industries, supplier credit ratings are sometimes better than those of the buyers. However, suppliers might still value the platform even in these circumstances. Cashflow certainty and having the flexibility to improve short-term liquidity when required are important value-adds.

The bank perspective
Reverse factoring is both good news and bad news for banks. Lending to suppliers at rates closer to those of the buyer means that margins for supplier banks will be eroded. For bankers to SME suppliers, some form of cannibalization is inevitable. On the positive side, getting access to a large share of a buyer’s supply base means potential new customers and cross-selling opportunities.

An important consideration for banks is whether they build the internet-based systems themselves or partner with specialist service providers – both of which have some merit. Early indications are that buyers want open platforms, as the prospect of a costly integration with a series of proprietary bank platforms is not appealing. Buyers’ preference may be for a bank independent platform with banks competing to provide the finance element.

Another consideration for a bank is the potential size of the lending business it might win on the back of a reverse factoring deal with a large global buyer. Large retailers, which are most interested in this service, typically spend well over €10 billion every year with more than 2,500 suppliers. Winning this business can quickly put a €1 billion asset onto a bank’s balance sheet – an exposure that might need to be syndicated or securitized in order to partly remove it from the balance sheet.

In conclusion, it is important to consider SCF in its broadest context and not as being simply synonymous with reverse factoring. Visibility across physical and financial supply chains by extracting key event and trigger information from the electronic environment is altering the landscape for banks.

Improved information throughout the P2P processes should mean that the quality of financing services provided by the banks will improve. Similarly, the move away from paper-based bank processes should result in lower costs and more sophisticated risk management.
Many finance and supply chain directors now appreciate the benefits of a financial supply-chain management (FSCM) approach and recognize that apparently disparate projects such as Electronic Invoice Presentment and Payment (EIPP), Electronic Bill Presentment and Payment, reverse factoring, supplier portal development and trade compliance should be coordinated as part of a broader FSCM programme.

To get the best returns from these projects, they should not be managed separately but must be aligned with relevant physical supply-chain projects. The financial and physical supply chains are becoming woven together as both become more dependent on common electronic data. Around 70% of the critical information contained in a purchase order, packing list, shipping document or an invoice is common to each document.

The drive for end-to-end visibility and key event management for a logistics manager is equally as applicable to the CFO. Teams responsible for building financial and physical supply-chain strategies need to work closely with the team responsible for shaping information systems strategy. These same teams need to encourage strategic supply-chain partners to contribute to this process.

An integrated physical and financial supply-chain strategy aligned with the groups’ information systems strategy should be a priority for companies embarking on FSCM. The challenges around stakeholder engagement, partner collaboration and implementation need to be considered carefully.

### Working capital management projects

Working capital improvement is a crucial matter for finance and treasury departments. There are usually a range of concurrent working capital projects under way at any one time within most companies: these include better cash management, improving receivables, extending payables, reducing inventory and eliminating buffer stocks of cash and stock, which are typically found throughout the supply chain.

These projects are often run and
managed by a range of business units within companies and rarely form part of a coordinated FSCM programme. Such insular projects also tend to be inward-looking and do not involve external stakeholders. Often, delivered benefits fall well short of expectation. In contrast, cross-functional working capital management teams that include suppliers and key supply chain partners have been shown to deliver markedly better results.

Reverse factoring projects
One working capital related initiative that has received considerable attention as interest in FSCM has increased is the improvement of the accounts payable process and the extension of payment terms. The impact of extending payment terms by 15 to 30 days can be significant for the buyer. Equally it can have a pretty detrimental impact on suppliers’ working capital and, historically, such initiatives have been resisted. However, new instruments for reverse factoring (RF) offer the buying organization a means to mitigate some of the negative impact of extended terms on suppliers.

The commercial logic behind RF is for the buyer to use its credit rating and access to cheaper finance for the benefit of its suppliers and supply-chain partners such as carriers and freight forwarders. This might be to
mitigate the negative impact of extended payment terms or maybe just to help suppliers reduce their cost of finance in order to be able to reduce unit costs in the future with payment terms staying constant. If the second option is the driver, then the change management and implementation process is relatively simple. However, if the principal driver for using RF is to extend payment terms, the buyer can face significant implementation hurdles from an operational perspective. In simple terms, the buyer communicates to the supplier base that the invoice presented has been approved and the supplier is given the option of taking payment at 60 days or taking early payment but paying a discount to an agreed lender for this payment. The cost of this discount could be less than the cost of finance that the supplier currently enjoys from its own bank, which might be as much as 400 basis points. However, this is not always the case and a first priority is to understand which suppliers might not benefit from a lower cost of finance.

A derivation of the process described above would be that the buyer makes the early payment facility available to the supplier using its own capital and calculates an early payment discount that is typically higher than its own cost of capital. Early payment discount rates of 2% are not uncommon. Depending on the value of the contract, this could equate to a great return for the buyer but translates to a cost of finance for the supplier somewhere between 30% and 40%.

The treasurer in the buying organization may be less than enthusiastic for this approach as, from his perspective, early payment represents a cash outflow and a worsening working capital position.
However, the buyer would argue that as the unit price is reduced then the accounts payable liability is lower, as is the value of the inventory booked, and that the impact on the profit-and-loss statement is more attractive.

The lesson is that treasury needs not only conduct a cost-benefit analysis but also needs to engage to procurement. The buyer, who tends to own the relationship with the supplier, may have a different perspective on the merits of extended payment. Once targets are aligned, the next challenge for the joint team will be to assess the size of the business opportunity and, more particularly, ascertain how many suppliers and what values of spend are likely to be driven across this platform. Buyers will be keen to calculate the size of the benefit from the supplier perspective.

Supplier engagement
Buyers take one of two routes in terms of supplier engagement. The first is to mandate the new arrangement as a condition of continuing to do business with the supplier. The second is to work with the supplier to help it appreciate and quantify the benefits of the new platform. Some of the benefits from the supplier perspective include cashflow certainty, access to cheaper finance and a faster invoice approval process.

Elements that might result in low take-up are additional costs to access and use the platform and complexity of use. If the driver is cheaper finance, the buyer needs to understand how many of his suppliers will benefit from the cheaper finance. Suppliers that have lower financing costs might still value the service because of the flexibility of liquidity it gives them. From a balance sheet perspective, it might be better to take an early repayment than seek to borrow and increase gearing.

The cost of this type of finance is important to the supplier but the tenor of the finance is also important. The real value of cheaper finance over 60 days is severely undermined if it takes the buyer 20 days to approve the invoice, thus reducing the borrowing period to 40 days. Buyers need to assess how good current approval processes are and how easy it will be to make this information available to the supplier or the platform provider. Connectivity to an EIPP project therefore becomes important.
The buyer business case
Another important part of the business case process for the buyer is determining the cost of the platform and RF service. The main options include: building a platform themselves using their ERP, their supplier portal and buying in the appropriate systems and then partnering up with one or several lenders; connecting to a third-party application service provider platform that has pre-arranged relationships with lenders; or using a bank or other financial institution platform and service.

The business case, supplier uptake and systems platforms are critical factors but there are a range of other issues that buying organizations need to consider.

Early payment translates into supplier finance and buyers are concerned that their accountants might reclassify a trade creditor position as bank debt. Typically, this is something treasurers are keen to avoid.

The scheme needs to be carefully constructed to avoid unacceptable impacts on the balance sheet and accounts. For the lenders, there are a number of complexities around recourse, security and legal obligations that need to be carefully considered, not just in terms of whether they are acceptable or not but in terms of the costs that might be attached.

Securitization
For very large buyers, the scale of the scheme is another important consideration, not just in terms of the number of suppliers involved and the different potential geographies, but also in terms of the value of the early payment or finance involved. Bank exposure can quickly increase and this has implications in terms of risk, size of asset on the balance sheet and required returns on capital thresholds. Syndication and securitization are routes for a lender to take this off balance sheet but have costs associated that need to be appreciated by a buyer organization.

Reverse factoring in Europe is still in its infancy but a number of well-publicized schemes are under way. Implementation challenges that have been identified can be split into three areas:
● process redesign as buying organizations ensure that invoice receipting and approval processes are streamlined and feed the necessary information into the reverse factoring platforms;
● system integration as buying organizations integrate a range of accounts payable systems into the RF platform;
● supplier enablement.
Best-practice supplier enablement involves the segmentation of the target supply base and the application of supplier onboarding techniques suitable for each segment.

Reverse factoring is an important but nevertheless small element of the overall financial supply chain. Exploring some of the issues at this level is equally relevant at the programme level.

Good examples include building teams from across functions and working with a range of partners to extract the greatest benefit not just for the buying organization but also for the suppliers and the supply chain partners involved.

Departments implementing function-specific initiatives need to be aware of the broader process impacts inside and outside the organization as the solution often involves overlapping technologies and shared systems. Understanding the interdependencies across financial supply chain process and how concurrent projects around working capital and risk management, compliance and dematerialization best fit together is the first objective.

The next is to understand how these fit with the groups’ information systems strategy and what the supply-chain management teams are doing in relation to the physical supply chain.

FSCM is a rapidly evolving a discipline and some of the more exciting collaborative initiatives like reverse factoring have some way to develop.

Best practices are therefore still being tested and, in the spirit of partnership and collaboration across supply chain, beginning to be shared across a number of converging sectors.
We hope you have found the articles in this handbook useful. If you would like to give us your feedback or comments, or to arrange a meeting to discuss some of the issues and opportunities identified, please contact the author, Paul Robinson at: paulrobinson@hsbc.com

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