The evolution of trade & supply chain

Lionel Taylor, managing director of Trade Advisory Network, seeks to promote discussion and stimulate the thought processes to drive much-needed innovation in supply chain finance.

In March this year the ICC finally published the long-awaited *Standard Definitions for Techniques of Supply Chain Finance*. This publication is a welcome addition that encapsulates the various financing and risk mitigation practices that have evolved over time to support those buyers and sellers who wish to trade with each other and those financiers and risk takers looking to share or distribute risk.

The drafting group were sensible to recognise that supply chain finance "is not a static concept" as the practices and techniques continue to evolve and this article is centred on that evolution.

Growing up in the UK factoring sector in the early 1980s, life was simple. We understood that cashflow was the blood stream of growing SMEs and that to stay healthy and prosper they needed support to accelerate the cash flowing through their businesses. Our sector focused on managing the risks of providing such facilities to clients and this meant that much time was spent understanding the mechanics of our client's business and the subsequent validation and measuring of behaviour and trends.

The ICC document makes reference to the physical and financial supply chains of businesses and there is an underlying premise that the service provider understands the trade cycle of the business they are looking to support. Those experienced practitioners are well versed in understanding the financial impact of events that take place in the physical supply chain and that the data emanating from those events has been the bedrock of traditional trade finance.

Sounds sensible, but how many of the new alternative financiers, obsessed with a view that the client priority is predominantly the need for an instant decision, really understand the businesses they are looking to fund, or worse still, looking for investors to finance. Has the obsession of speed overtaken the fundamental need to understand not just the trade cycles of the businesses looking for funding, but also their motives in taking that funding? I guess time will provide the answer, as the majority of the funders established in today's benign economic climate are yet to face the grim reality of trying to keep a finance company on track during a recession.

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Lionel Taylor, Trade Advisory Network

In fairness, it would be wrong to categorise all "alternative financiers" as the same. Our business, Trade Advisory Network, is engaged in helping some of these companies strengthen their new business and credit processes through our trade cycle analysis (TCA) approach. Many of the entrepreneurs running these businesses are very bright and bring a 'can do' attitude that is often refreshing. They are using technology proactively to not only improve the service and access for clients but also to solve and improve control issues as they arise.

Much has already been written about the consequences of the financial crash. Headlines often spurred on by political opportunism talk about the banks being closed for business, especially to their SME customers, and others predict that the banks will lose whole revenue streams to the new "disruptors". The banks, while continuing to prioritise regulatory demands, are aware of the business threat from non-bank alternatives, and with payments becoming more and more commoditised, some are seeing trade and working capital as a growth area to add value and generate revenue.

Many are breaking down individual product silos in an attempt to create a more cohesive business. The bringing together of the previously separate factoring and trade businesses makes good sense and certainly fits well within the banner as defined by the ICC definition of supply chain finance. Such integration takes time, as not only different cultures, but also different and often unconnected systems and architecture, are brought together.

However, this also brings great opportunity for innovation. Both the factoring and trade finance communities have been very slow in embracing new technology. Over the years, there has not been much system or proposition development in the factoring world and investment in trade has taken a back seat as the banks have focused their investment on mandatory requirements and on developing their mainstream electronic commercial banking platforms.

Examining client need

To understand where the opportunities are and where the investment cases will be won, it is worth revisiting the client need and then considering how new technologies can be used to create more efficient processes and build new propositions to meet those needs.

Client need tends to be primarily

Understanding the Supply Chain

Physical Supply Chain

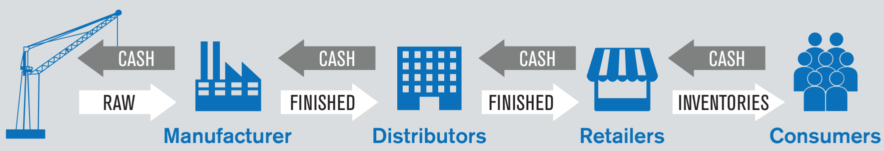
- A network created amongst different companies producing, handling and/or distributing a specific product
- Specifically, the supply chain encompasses the steps it takes to get a good or service from the supplier to the consumer

Financial Supply Chain

- Reflects the financial impact on the physical supply chain

Information Supply Chain

- Data from various sources that enables a financier to use event-driven data to drive a financing/risk mitigation solution



focused on risk and in the management of cashflows. Risk can be further broken down into the performance risk of supply and the credit risk of non-payment. The risk mitigation, finance and settlement provided by a typical letter of credit (LC) facility for many years provided the foundation for international trade.

Today with less than 15% of global trade settled by bank-intermediated, transactional trade finance, it would be easy to conclude that the protection and support given by such structures is becoming redundant. However, as shown by increasing levels of late payment and bad debt as well as the growth of credit insurance, the client need has not dissipated.

In my view it is no coincidence that many banks now recognise that the onerous and costly paper-based nature of transactional trade finance needs a revamp. Growing digitisation will help and should pave the way for more streamlined and efficient processes, which hopefully will translate into cheaper pricing. However, the real prize lies within the application of new technologies.

Blockchain or distributed ledger technology has risen in prominence with the likes of bitcoin, but some practitioners have been using this technology for many years as a way of simplifying or streamlining what may have been deemed as complex structures. At Trade Advisory Network we are now increasingly being used as subject matter experts to work with some of the main blockchain technology providers to re-examine how this technology can be applied across traditional trade.

Our belief therefore is that it will not be long before the application of this technology will radically streamline the processes involved in traditional trade and provide an opportunity for banks to promote the risk mitigation benefits of documentary trade in a 21st century way.

Working capital and the management of cashflow is vital for business. History is littered with seemingly profitable companies ceasing to trade because they have run out of cash.

Traditional trade, while offering finance on a transactional basis through loan type structures, has for many seemed too structured and clunky.

Open account financing structures tend to revolve the issuance of a sales invoice with the financing of the resultant receivable whether provided through factoring, invoice discounting or receivables purchase. Such facilities are commonly provided on a flow basis with the client having an availability of finance against an eligible receivables balance. Supplier finance operates on a similar basis but here the funder places reliance upon the approval of the debt by the buyer.

Such receivables and approved payables finance propositions play an important role in the financing of businesses and many of the new fintechs and alternative financiers have entered this space to fill in gaps, whether related to single invoice financing or the provision of approved payables finance to non-investment grade buyers. Interestingly, some of those providers have fallen back on the traditions employed in forfaiting with the use of bills and promissory notes as a risk mitigant.

However, when reviewing the client need, all have focused on the invoice. This post-shipment finance falls short of the real needs of business to be financed earlier in the trade cycle.

Traditional trade has been able to provide such pre-shipment finance on a transactional basis using the total control and visibility of the documentation that is generated from the physical supply chain. In the open account space funded, as previously mentioned, on a flow basis, funders do not have the same level of control and visibility and as such have not felt comfortable funding on a pre-shipment basis.

However, the market opportunity to develop an open account end-to-end financing proposition is on the agenda for many of those involved in blockchain technology. At Trade Advisory Network we are increasingly involved in proof-of-concept discussions investigating how the data can be received, validated and shared within the transaction cycle that will allow funders to be more comfortable that purchase orders are confirmed and that suppliers are fulfilling their contractual obligations.

The future of trade

It is our view that eventually a financing formula taking into account the value generated at, say, four main stages of the transaction cycle (purchase order – goods shipped – invoice raised – invoice approved) could be calculated to provide a funding availability on a flow basis, not unlike existing invoice finance models.

Also, recognising that a single bank may not be best placed to effectively evaluate both the performance risk on the seller and the credit risk on the buyer, there is the opportunity for the respective banks of the seller and buyer to collaborate with each other through the blockchain. Here we see a potential role for an evolved Swift Bank Payment Obligation to support such relationships.

We at Trade Advisory Network are passionate about both the evolution of traditional trade and the development of flow-based supply chain finance in the open account space, and are keen to work with banks and non-bank financiers to develop blockchain-based solutions.