

Supply Chain Finance: What Is It, How Does It Work, and Is It Worth the Risk?



Time-tested but nevertheless controversial, the practice known as *supply chain finance* (SCF) has a long history in the business world. In fact, companies have relied on some form of this practice to help them obtain the goods they need to compete since the dawn of commerce.

Today, global supply chains continue to evolve in the wake of the COVID-19 coronavirus pandemic.

Eager to boost resilience and agility while securing working capital that can help them grow and compete, organizations are taking notice of a fast-growing supply chain financing market—one incorporating both traditional financing models and newer approaches that leverage the tools of digital transformation.

When it's properly managed and executed, supply chain finance has substantial benefits for all parties involved.

But in order to realize its full potential, it's important for buyers to understand how SCF works, the changes in the market that are making it more popular than

ever, and how to gauge and manage the associated risks.

What Is Supply Chain Finance?

While it resembles traditional trade finance superficially, modern supply chain finance has evolved from its roots.

It is generally used to open account trade between buyers and sellers with established relationships (as opposed to organizations with little or no history).

It includes not only traditional third-party funding models, but emerging, platform-driven systems based on digital technologies.

All commercial activities are driven by two connected but distinct supply chains:

- **Physical supply chains** involve the flow of goods and services from suppliers to manufacturers to retailers to end users/customers.
- **Financial supply chains** run opposite to their physical counterparts and involve the flow of money from customers back to suppliers.

Supply chain finance is the set of practices and workflows banks and other financial institutions use to manage this flow while mitigating risk where possible.

Every step in the physical supply chain is a trigger for one of three financial activities in the supply chain financing program: financing, risk mitigation, or payment.

These triggers include:

- Issuing a purchase order.
- Inspection of goods before shipment.
- Shipping goods.
- Vendors issuing invoices.
- Receipt of the goods by the buyer.

Supply chain finance is also known as *buyer-side finance*, as it is commonly used to cover supplier financing for large buyers.

However, small and medium enterprises (SMEs) looking to circumvent the limitations set by traditional creditworthiness paradigms also rely on it to obtain

the goods they need, as successfully entering into an SCF relationship with a financial institution or other supply chain finance provider can serve as a “credit check” on its own.

In addition to traditional three-way financing, two emerging methods of trade finance gaining steam with supply chain financing professionals are:

- **Reverse factoring**, wherein a platform provided by a funder (e.g., a bank, fintech organization, financial consortia, etc.) is accessed by both the buyer and supplier. Financing is based on invoices approved by the buyer.
- **Dynamic discounting**, wherein both buyers and suppliers connect to a (usually independent, fintech-backed) platform and negotiate invoice discounts and modified payment terms directly, without the need for a third-party funding solution.

It’s worth noting that while reverse factoring and dynamic discounting accounted for just \$0.4 trillion and \$0.1 trillion of financed assets in 2019, respectively, research conducted by McKinsey & Company indicates they are poised to experience explosive growth by 2024.

Other techniques include, but aren’t limited to:

- **Receivables discounting:** Companies discount all or part of their receivables to their financial institution to secure a fast injection of cash.
- **Factoring:** A bank or specialized factoring house advances sellers 70%-90% of outstanding invoices up front, and then pays the remainder (minus fees) upon payment. Factoring is very popular with SMEs looking to secure a de facto “credit check” to establish creditworthiness in the short and long term.
- **Forfaiting:** The purchase of receivables with no recourse for recovery. Banks and financial institutions give cash to sellers based on invoices or promissory notes guaranteed by the buyer’s financial institution. Forfaiting transactions tend to be very high in value.
- **Payables financing:** Sellers can receive payment from a bank for outstanding invoices, before their due date and at a discount, including a financing fee from the bank itself.
- **Distributor financing:** The distributor for a major manufacturer

receives funds required to protect liquidity and cover inventory costs for goods to be resold until they can generate receivables through the sale of goods to retailers or customers.

- **Pre-shipment financing:** SMEs with substantial profit margins but tight cash flow can maintain working capital by obtaining financing against purchase orders, demand forecasts, or commercial contracts using this method.

SCF should not be confused with:

- **Documentary business**, which focuses on traditional methods of off-balance-sheet trade finance tools such as bank payments, letters of credit, and international guarantees for outstanding balances, used to insulate buyer and seller against transaction-related risk. In this model, the supplier sends all the shipping documents related to a transaction to their bank or financial institution, who then coordinates with the buyer's financial institution to complete payment.
- **Seller-side finance**, which includes both factoring (e.g., purchase order financing) and invoice financing. These tools are used to secure the financing needs of sellers by anticipating transaction-related liquidity. In this model, the supplier sends all information to their receivables financing to their bank, and then borrow against the value of their accounts receivable.

Note: Factoring is distinct from reverse factoring. The former is a short-term financing solution focused on the sale of invoices to a factoring company at a discount in exchange for cash up front.

SMEs in emerging markets are particularly eager to move beyond old paradigms and embrace modern SCF. They want financial institutions to look beyond credit ratings alone and understand speed, agility, and resilience are hallmarks of both survivability and competitive strength in today's complex global supply chains.

How Does Supply Chain Finance Work?

Traditionally, supply chain finance follows a basic series of steps:

1. A company (the buyer) enters into an agreement with a supply chain finance provider (traditionally a bank or other financial institution) to cover the amounts the company owes to its suppliers.
2. The company places an order for goods with a supplier.
3. The supplier sends goods to the purchasing company. The company agrees to pay the balance on their purchase within an established timeframe (usually between 30 and 180 days).
4. The supplier sends the invoice for the goods to the financial institution,
5. The financier pays the invoiced amount upon receipt, but at a discount rate based on the amount of risk incurred.
6. The purchasing company pays the financier at the time specified in their agreement.

Consider Company XYZ, a fine goods importer. They enter into a credit relationship with ABC Bank and then enter into formal purchasing agreements with their suppliers.

The suppliers send their receivables purchase agreements with XYZ to ABC bank.

When XYZ makes a purchase, their suppliers send their invoices for approval and payment to XYZ, who forwards them to ABC.

ABC issues payment to the suppliers, capturing early payment or other discounts as specified in their agreement with, and as requested by, XYZ.

Finally, XYZ pays ABC the full invoice amount, on the original invoice due date.

Why Supply Chain Finance Is Important

Supply chain financing benefits all three parties involved, as the financial institution effectively accepts the payment risk for both buyer and seller in exchange for a fee it recovers upon payment of the full amount.

The buyer gains access to the goods it needs to do business while maintaining greater flexibility in its cash flow management, and suppliers can confidently do business with a diverse range of organizations, knowing they'll be paid (and therefore manage their own working capital more effectively).

The most basic approach to supply chain finance has historically limited the

interest of financial institutions to large buyers whose purchases generate revenue commensurate with the associated risk.

However, in the new global economy, where supplier lists can include hundreds of companies across the globe, new paradigms and tools are making SCF practical and attractive with lower financing costs, less risk, and a higher likelihood of win-win scenarios for all parties involved.

In addition, as more companies seek to diversify their supply chains to build resilience and insulate against risk, SCF will only grow in importance as both established organizations and SMEs from diverse marketplaces seek funding necessary to grow, compete, and innovate.

In the new normal created by the coronavirus pandemic, adoption of technologies such as the blockchain, centralized digital data management solutions, process automation, and advanced data analytics is changing the way companies are approaching supply chain financing.

Advanced technological capabilities reduce risk (e.g., blockchain-secured transactions) and provide greater resiliency and agility (more collaborative and communicative vendor and supply chain management coupled with procure-to-pay optimization via a comprehensive software solution like PLANERGY).

Companies who embrace SCF acknowledge the growing importance of big data as the driving force in commercial enterprise, and how technology can help buyers, sellers, and funders leverage data to minimize risk and maximize return on investment.

And most importantly, they understand the need for new approaches to decision-making and process development.

Today's bank-led financing paradigms may soon be only a small part of tomorrow's fintech-driven, collaborative platforms where buyers and sellers can connect with diverse sources of secure funding and do business with confidence.

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competitive strength in today's complex global supply chains.

The Challenges and Risks of Supply Chain Finance

Despite its ubiquity, supply chain finance is not without risks and controversy.

As they are shifting transactional risk from the buyer to themselves, financial institutions and other funders need clean and complete data in order to make intelligent and risk-effective funding and credit decisions.

For their part, buyers also need complete and transparent spend data in order to plan their cash flow and ensure they meet their deferred, but still very real, obligations to the funder without limiting their access to working capital or damaging their relationships with suppliers and lenders alike.

Digital transformation remains a challenge as well. Its promise remains largely untapped, although McKinsey found 93% of respondents in its 2020 survey planned to incorporate digital tools in order to increase their supply chain resilience as part of their pandemic recovery strategies.

Fragmented supply bases and increasingly diverse sources of funding will require the birth of new consolidating platforms that allow buyers, funders, and sellers to do business while effectively managing risk and financial planning.

New APIs, data sharing tools, and standards and practices must be developed to accommodate these needs in order for SCF to adapt to the changing needs of the market.

SCF also needs a facelift in the accounting department. Currently, companies who use supply chain finance providers classify debt owed to financial institutions as part of their general accounts payable, rather than outstanding debt to the funder. They can provide clarification at their discretion, but it's not required.

A popular and widespread tool that lacks clear disclosure requirements is understandably a source of concern for a variety of regulators and rating agencies.

In fact, the Big Four audit firms (Deloitte, PriceWaterhouseCoopers, Ernst &

Young, and Klynveld Peat Marwick Goerdeler) issued a letter in 2019 to the Financial Accounting Standards Board (FASB) asking that the Board “provide disclosure requirements to increase the transparency of such programs whether the obligations are classified as trade payables or debt.”

This concern seems more than justified, as supply chain finance has been involved in multiple corporate disasters, including the implosion of Spanish bioenergy giant Abengoa, the collapse of U.K. construction firm Carillion, and the \$10 billion dollar credit freeze issued to Greensill Capital by Credit Suisse.

Moving forward, it’s clear that companies and financial institutions who want to reap the benefits of SCF will need not only an understanding of how it works, but a willingness to embrace greater regulation and a willingness to upgrade their toolkits with digital technologies.

For these organizations, transparency and collaboration will define successful supply chain finance programs and help ensure shared success.

Supply Chain Finance Has Rich Rewards for Those Who Appreciate the Risks

Global trade is more complex than ever, and whatever form it takes in the coming years, supply chain finance will likely remain an attractive option for buyers, financiers/financial institutions, and suppliers who value resiliency, speed, and agility.

For those who understand the risks involved, embrace the new technologies supporting emerging platforms, and strategize accordingly, leveraging supply chain finance programs can lower costs, provide entry to new markets, improve cash flow management, and strengthen global supply chains.

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