Chain gain

AT THE REQUEST OF THE BANK OF ENGLAND, THE ACT HAS LED A MAJOR STUDY INTO SUPPLY CHAIN FINANCE. **PETER WILLIAMS** HAS BEEN READING THE REPORT, WHICH IS BASED ON A MARKET REVIEW CONDUCTED BETWEEN SEPTEMBER 2009 AND MAY 2010.

A year ago, with bank lending to smaller companies seen as constrained, the Bank of England asked the ACT to examine alternative ways of providing additional capital to this important part of the economy. One of the main goals was to assess whether there was demand for an expansion of the supply chain finance (SCF) market.

The ACT-chaired working group that undertook the study has concluded that, although no particular SCF structure should be singled out as the preferred option, buyer-driven receivable programmes will help ease funding conditions in current market conditions.

BARRIERS The report identified four main barriers to expansion of the SCF market:

- understanding of the differences between the various SCF mechanisms is generally poor;
- the UK SCF market is funded by relatively few banks;
- a negative misperception exists about the use of SCF mechanisms; and
- accounting for SCF mechanisms is complex and uncertain, which is unhelpful.

Despite these barriers, demand for SCF mechanisms is growing and both the finance volumes and number of providers are increasing.

SCF is a term used to define the financial relationship linking the buyer and the supplier together in terms of payables and receivables.

The study identifies several SCF structures in four main categories:

- supplier-driven programmes – receivables, factoring/discounting;
- purchasing cards;
- inventory finance; and
- buyer-driven programmes.

These structures have developed to suit a variety of needs and the working party believes no one option should be preferred above the others. However, in market conditions where lenders are concerned with credit quality, the working group believes that buyer-driven programmes can and will help ease funding conditions.

Before deploying a SCF solution it is important that everyone involved in the deal understands the drivers. Traditionally, SCF has been used by buyers or suppliers to address adverse market conditions. These conditions have led many purchasing departments (buyers) to extend payment terms for their suppliers (that is, to pay them later). Those suppliers are then forced in turn to look for alternative solutions to receive their payment in a timely fashion.

Factoring and invoice discounting, the most commonly recognised forms of supplier-led SCF in the marketplace, have traditionally not been well regarded, and suppliers have often been keen not to disclose to buyers they are using these products. The working party believes this stigma is misconceived.

BUYER-DRIVEN RECEIVABLES Buyer-driven receivables programmes (BDRPs) have two key benefits that make them attractive to lenders:

- the buyer, not the lender, is responsible for dealing with the supplier (for instance, dealings with adjustments as a result of returned goods); and
- the funding is based on the credit standing of the buyer and not the supplier.

As a result BDRP is less complex than other structures. And where the buyer's credit is stronger than those of its suppliers funding is likely to be less expensive for suppliers. Some recently introduced BDRPs involve banks that have not previously participated in the UK SCF market.

DOCUMENTATION A characteristic of many successful financial markets is standard documentation. The report calls for an industry body to be set up to develop voluntary principles and/or standards documentation for SCF programmes. The body would need to include lenders, buyers, suppliers and legal representation, and the involvement of government and non-bank investors would stimulate wider investor interest in SCF structures.

The working party also considered the longer-term goal of whether an SCF programme could issue a tradable asset

Box 1: Study participants

The working group included a broad range of stakeholders but in particular the ACT acknowledges the contribution from the following organisations:

- Asset Based Finance Association (ABFA)
- KPMG
- Legal & General Investment Management
- Orbian
- Squire Sanders

A number of other organisations that participated with enthusiasm preferred to remain anonymous.

ASSET-BACKED COMMERCIAL PAPER IS AN ESTABLISHED FUNDING MECHANISM THAT COULD PRODUCE A TRADABLE INSTRUMENT BASED ON SCF ASSETS.

purchasable by a range of investors. Banks, including overseas banks, have been encouraged to participate in this area by the growth in the use of BDRPs but non-bank investment in SCF is mixed.

For instance, money market funds (MMFs) are unlikely to buy SCF assets at the moment and non-bank investors are risk-averse and lack the resources to evaluate numerous and varied structures. They favour formally rated corporate bonds or commercial paper but would consider investing in SCF structures, in particular BDRPs, if the market could be developed and standardisation introduced. Asset-backed commercial paper is an established funding mechanism that could produce a tradable instrument based on SCF assets, although other options are available.

EASING LENDING CONSTRAINTS SCF already exists in many different buyer-led and supplier-led guises. Within the constraints of the various products available it fulfils a valuable role in providing working capital to a diverse range of companies. The finance provided has grown, particularly through BDRP, and the marketing undertaken by providers implies an expectation of further growth.

However, SCF could provide substantially more funding if certain barriers could be overcome. In particular, the report concludes that SCF has a part to play in helping ease lending constraints, especially for small and mid-tier companies and those with a weaker credit standing. At a time when bank lending is constrained, larger corporates in particular have turned to public debt markets for their funding needs. However, a considerable number of small to mid-tier companies cannot access non-bank funding. SCF, and in particular, BDRP, offers opportunities to expand lending to these companies. Larger companies, as buyers, can play a significant role by facilitating BDRPs in which their supply chain can participate. The benefits to suppliers can feed back to buyers in terms of better relationships with suppliers and a reduction in possible financial weakness/instability of suppliers.

The working group believes that the SCF market will benefit from a co-ordinated industry focus on increased standardisation, which in the long run will lead to non-bank investors entering the market.

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To read the report in full, go to:
www.treasurers.org/scf

For more on the different structures of SCF programmes, see the Autumn 2010 issue of the Cash Management supplement, p14.

Box 2: Next steps

Provision of information, education and a practical guide to SCF is seen as the prime need to stimulate all sides of the market. The bodies involved in the working group are well placed to undertake this, both directly and by stimulating publicity around the subject.

The recommendations of the working group remain just that: recommendations. For them to become effective, an existing body or a new coalition of interested parties need to take forward the concepts of SCF programmes.

Greater transparency will encourage new funding institutions to enter the market, but further work is needed on developing a funding instrument that is capable of gaining a degree of liquidity. The working group did not find that securitising the receivables and financing through a special purpose vehicle was a prerequisite. Simplicity and legal certainty was required, so that some acknowledgement of the payables, or a tradable instrument like a bill of exchange, could be devised.