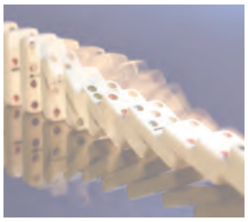
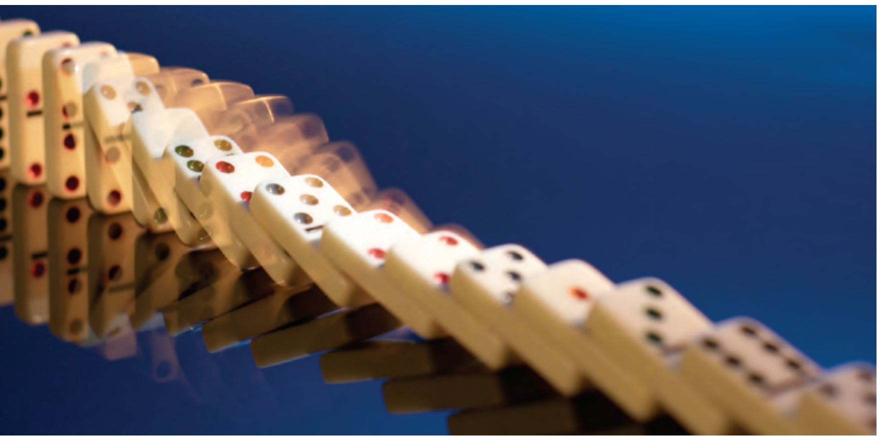


Looking for a chain reaction

SUBSTANTIAL BUSINESS OPPORTUNITIES AWAIT THOSE WHO ARE BOLD ENOUGH TO ESTABLISH A SYSTEM TO MANAGE THEIR FINANCIAL SUPPLY CHAIN, SAYS HSBC'S **REBECCA ADRIATICO**.



Executive summary

Good management of your financial supply chain can bring valuable business benefits, but there are as many definitions of FSCM as there are people who deal with it. Key factors to address are the move to paperless automation, collaboration with suppliers, managing working capital effectively and replacement of letters of credit with open account.

Financial supply-chain management (FSCM) is not a new concept. As more and more large corporates explore ways to improve working capital management and reduce costs, not only for themselves but their suppliers, the financial supply chain (FSC) has presented itself as a largely untapped area of business opportunity.

Ask CFOs, treasurers, chief procurement officers (CPOs) and logistics managers what FSCM means to them and you will likely get a wide variety of answers. At the heart of every definition is the management of working capital and payment flows. Equally important, however, is the management of information across the supply chain and the documents and data that support these flows, such as purchase orders, advanced shipping notices, invoices and payment approval processes.

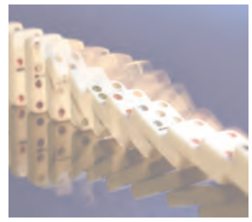
MANAGING THE FLOW OF INFORMATION The importance and value of paper's dematerialisation and automation in FSCM cannot be underestimated. According to industry analysts, in today's paper-based environment matching purchase orders, goods received notes, certificates of inspection and invoices can take about 55 days to complete. If a buyer has settlement terms of 60 days this doesn't leave much opportunity to consider possible financing options for their supply chain partners.

While many large buyers have enterprise resource planning systems in place to help drive automation and create efficiencies, they are still bombarded with paper from about 90% of their supplier base. Getting suppliers onto automated platforms, be it for invoicing (EIPP) or supply chain financing, continues to be one of the key challenges in eliminating paper in the financial supply chain. Given that suppliers will likely have to link to myriad buyers and buyer ERP systems, convincing them of the business case for the move is critical. Supplier enlightenment and engagement at a local level is the key to solving this problem.

A collaborative approach must be taken by all parties in the FSC to make sure that data can be stored, re-used and passed on in a standard, automated format with low barriers for adoption in order to drive widespread take-up.

To realise the hard business benefits, difficult hurdles have to be overcome. Getting individual sectors to adopt common standards and protocols has been a real challenge, but there are signs of progress, particularly in certain geographies and around processes like electronic invoicing. Some government-mandated systems and industry-specific closed user groups have shown real benefits to all participants. An interesting contemplation would be the role of governments in mandating a common platform for trade along the lines of SEPA. Would the single currency and payment area in Europe ever have happened if it had not been mandated by the EU?

The SWIFTNet Trade Services Utility is a good example of an industry initiative based on a common infrastructure and format. The TSU is a central data-matching and workflow engine that uses standardised, reusable, computer-readable data elements from commercial documents to increase automation and data checking. It facilitates communication of critical data elements between banks that allows for automated matching, which in turn makes it easier to effect



payments and finance trading between parties. Automation is used to improve the processing elements within the purchase-to-pay cycle and simplify the use of data within the process to support additional FSC requirements.

MANAGING WORKING CAPITAL EFFECTIVELY Practices and processes within international trade continue to change significantly as companies move away from letters of credit to more open account transactions, sourcing goods direct from low-cost countries and leveraging the benefits of increasingly cheaper technology.

The adversarial, buyer-driven approach to cost management is being replaced with the realisation that there are greater business benefits associated with working more collaboratively with suppliers to help them improve efficiencies and reduce their costs. The commercial logic for a buyer is simple: we will help you to reduce your costs but in return we expect some of these savings to be passed back in the form of lower unit prices or improved services.

The same logic is being applied to working capital management. The group treasurer understands that improving working capital by extending the payment terms to its suppliers might result in short-term gains but could prove costly in the long run as suppliers pass back the additional costs in the form of higher prices.

Within the buying organisation, finance, treasury and buyer teams need to work together to improve not just working capital but the way it is managed along the supply chain and for its supplier base. Buying organisations want suppliers to have access to cheaper financing, ensuring adequate resources are in place to keep suppliers liquid and healthy. Forcing suppliers to borrow at higher interest rates would translate into higher costs that could be forced back up the chain. Deteriorating supplier liquidity increases risk within the supply chain and can be damaging for all parties.

An obvious source of conflict within an FSC improvement programme is the different business drivers between the buyer and supplier organisations. Suppliers want to get paid quickly and reduce their days-sales-outstanding, while buyers want to delay paying as long as possible, extending their days-payable-outstanding. Where banks add value is by bridging this divide using structured financing products.

One traditional source of financing is the letter of credit. Suppliers have historically been able to leverage their letters of credit to obtain both pre- and post-shipment finance. Thus the ability to promptly convert bills presented against letters of credit has enabled a steady flow of liquidity for suppliers, enabling them to be more generous in extending terms to the buyer – an excellent source of supplier working capital.

If buyers are encouraging their suppliers to move away from letters of credit, alternative financing arrangements are needed. The last year has seen a marked increase in receivables financing and open account supplier financing services. Under a receivables financing scheme, the supplier usually acts as the bank's agent in collecting sums due from the buyers, and assigns or sells the receivables to the bank. The bank will buy the receivables at a going rate discount based on the buyer's payment history and anticipated insolvency risk, and the historical dilution risk between buyer and supplier.

SETTING UP AN FSCM PROGRAMME Extending payment terms may appeal to the buying organisation, treasurer and finance director but might be resisted by the buyers as they stand to lose negotiated early payment discounts. Gains from a better working capital position could be significantly eroded if the early payment discount is significantly higher than the buyer's cost of finance or capital. Additionally, as certain industries move away from letters of credit, two other factors should also be considered: changing risk environments and tax treatment of new financing methods.

As supply chain management focuses heavily on low-cost sourcing, contract manufacturing, off-shoring, managed services and outsourcing, the risk management profile of the supply chain has increased in complexity. The risks of bottlenecks, disruption and incurring unforeseen costs are greater in cross-continent and global supply chains than in a close-to-home supply chain. The growing incidence of disruptions resulting from embargoes, fraud, money laundering, terrorist acts and economic volatility all add to the risk profile of a physical global supply chain. The financial supply chain is also undergoing a shift in its risk profile as buyers, sellers and banks now have to be more comfortable financing trade in an open account environment.

A number of large multinationals with sourcing and production activities want to better manage their tax liability by re-engineering SCM processes and responsibilities to optimise customs duty, corporate and value added tax liabilities. Tax efficient supply chain management is an important offering for many accounting and management consultancy firms and should be considered as part of a broad FSCM programme.

FSCM as a discipline extends beyond just the remit of finance and treasury and must involve procurement. Successful FSCM initiatives typically also involve managers from accounts payable and receivables, risk, IT and compliance. Sustainable business benefits will only be achieved if these joint teams work across the supply chain – not just with key suppliers but also with third party logistics providers and banking partners.

Understanding the complicated dynamics of FSCM, and the increasingly sophisticated and demanding requirements of larger importer or buyer customers, is only the beginning. Harnessing and leveraging the developments in networked technology is also very important – not just to improve transactions management processes and reduce cost throughout the chain, but as a key enabler of supply chain finance and risk mitigation. Understanding and catering to the requirements of all supply chain partners, particularly small- to medium-sized suppliers in low-cost sourcing countries, is critical for sustainable improvement and longer-term success.

One thing is certain: this is going to be an exciting journey for those that embrace the challenge.

Rebecca Adriatico, Head of Global Product Management, HSBC Trade and Supply Chain
rebeccaadriatico@hsbc.com.hk
www.tradeandsupplychain.hsbc.com

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